



Investigation for the Board of Administration of the San Diego City Employees' Retirement System

Legal Analysis and Conclusions Prepared by
Reish, Luftman, Reicher & Cohen

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Privileged & Confidential
Prepared at the Request of Counsel

Navigant Consulting, Inc.
633 West Fifth Street, Suite 5900
Los Angeles, CA 90071

[213] 670-3200
www.navigantconsulting.com

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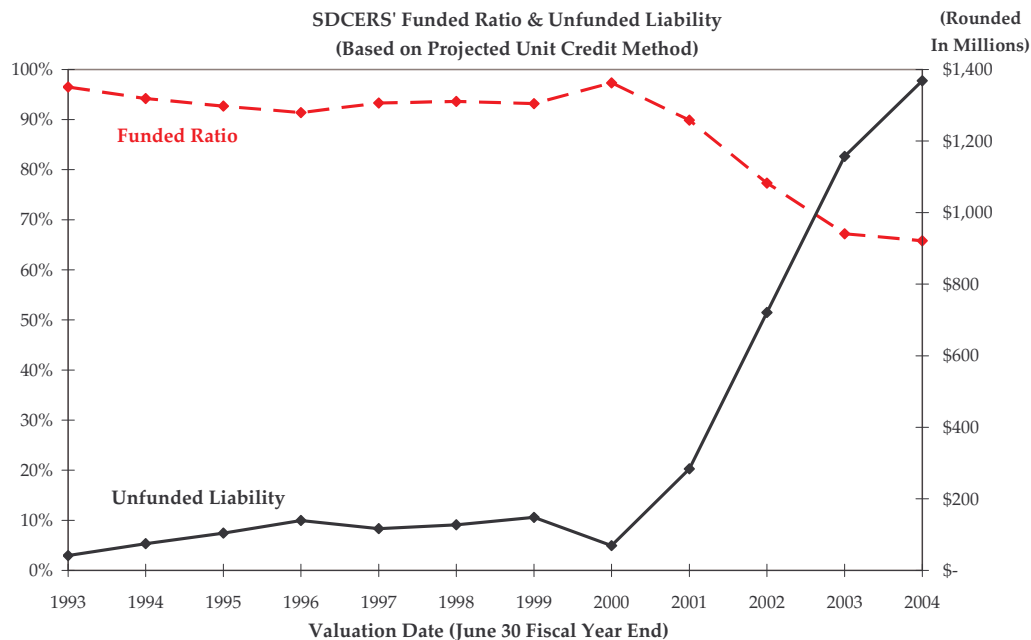
I. Overview

This report has been prepared on behalf of the Board of Administration (“the Board”) of the San Diego City Employees Retirement System (“SDCERS”, “System” or “Trust Fund”). The purpose of this report is to detail the results of the investigation of SDCERS conducted by Navigant Consulting, Inc. (“Navigant Consulting”). This report was prepared under the direction of the Board’s special fiduciary counsel, Reish, Luftman, Reicher & Cohen (“Reish Luftman”). The legal analysis and conclusions contained in this report were prepared by Reish Luftman. The contents of the report are covered by the attorney-client privilege subject to the Board’s ability to waive that privilege.

II. Circumstances Giving Rise to the Investigation

A. Historical Background

The genesis of the investigation was the underfunding of the defined benefit pension plan that was established by the City of San Diego (the “City”) for some of its employees. The funding shortfalls began at least as early as 1991 and continue to this day. From 1993 through 2000, SDCERS funded ratio¹ consistently remained in the 90% range or above with little change in the unfunded liability. Beginning in 2001, the unfunded liability increased while the funded ratio decreased as shown below.



Sources:

- 1) FY2003 SDCERS' Comprehensive Annual Financial Report (CAFR)
- 2) FY2003 - FY2004 Actuarial Valuation Reports

¹ See Attachment 1 for definitions of the terms used throughout this report.

The underfunding of SDCERS was a result of adjustments to the actuarial methods and assumptions used to calculate the City's contribution rate that arose when the City agreed to benefit changes during the meet and confer process and the SDCERS Board agreed to change the funding method. In 1995, the City requested SDCERS to allow the City to fund a portion of the City's contribution from reserves in order to reduce the City's annual contribution payment to SDCERS². In 1996, the City Manager requested the SDCERS Board approve contribution rates at lower than the actuarially determined contribution rate ("Manager's Proposal 1" or "MP1"). Then, in 2002, the City Manager again asked for changes to the contribution rate that included overriding the provision that required the City to pay a lump sum if the funded ratio dropped below a certain level ("Manager's Proposal 2" or MP2"). These actions were the primary factors leading to the underfunding of SDCERS.

In January 2004, the City made a voluntary disclosure filing regarding the pension underfunding and certain errors in the footnotes³ to its financial statements.⁴ At approximately the same time, the City hired KPMG LLP ("KPMG") to audit the City's restated 2003 financial statements and the Securities and Exchange Commission ("SEC"), Department of Justice ("DOJ") and others began investigating the City's disclosure practices. During 2004, the City also hired Vinson & Elkins L.L.P. ("V&E") to conduct an investigation and provide a report of the City's disclosure practices from 1996 through February 2004 and whether the City failed to meet its disclosure obligations. V&E issued its report dated September 16, 2004 and an additional draft memoranda report dated July 15, 2005.

In an October 11, 2004 letter to the City Attorney, KPMG stated "we do not believe that the City of San Diego has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken." In early 2005, the City then hired Kroll, Inc. ("Kroll") to conduct an additional investigation to review the City's internal controls related to reporting and disclosure pursuant to applicable securities laws. The SEC, DOJ and Kroll investigations are ongoing.

On January 6, 2005, the U.S. Attorney indicted five individuals, including three former Board members, the former SDCERS' Administrator and the current SDCERS' General Counsel.

² Fiduciary counsel, Morrison & Foerster LLP, advised the Board not to allow the transfer.

³ Examples of some of the City's errors in the footnotes include incorrect disclosure of (i) the interest rate and maturities of various San Diego bond offerings, (ii) total amount payable on operating leases for 2003 and (iii) the City's required GASB 27 disclosure for SDCERS.

⁴ The City's disclosure was made in filings with the Nationally Recognized Municipal Securities Information Repositories.

B. The SDCERS' Board's Decision to Conduct a Separate Investigation

In November 2004, the voters of the City passed Proposition "H" which resulted in changes to the composition of the SCDERS' Board. This Proposition resulted in an increased number of appointed members on the Board (i.e., individuals who are not current or former employees of the City) and fewer elected members (i.e., City employees).⁵ The new Board members who joined the Board following the passage of Proposition H began their terms on or after April 1, 2005.

In August 2005, with the advice of SDCERS litigation counsel, Seltzer Caplan McMahon Vitek ("Seltzer Caplan"), and special fiduciary counsel, Reish Luftman, the Board commenced an independent investigation into certain events and actions of its former Board members and Staff. The Board decided to conduct an investigation independent of the City's investigations by V&E and by Kroll.

The primary reason for the Board to decide to conduct an independent investigation related to the allegations that the System was underfunded. Although the System is underfunded by approximately \$1.37 billion, as shown as in the June 30, 2004 actuarial valuation⁶, and the City has not fully funded benefits during the period in which they were earned, SDCERS currently has sufficient assets to pay the retirement benefits for all of the current retirees. As disclosed in the June 30, 2004 actuarial report, SDCERS held assets with a market value of \$3.4 billion and an actuarial value of approximately \$2.6 billion. In 2004, SDCERS paid pension benefits, retirement benefits and administrative expenses totaling \$210 million.

III. Investigation Purpose and Scope

On August 30, 2005, the Board passed a motion to retain Navigant Consulting to conduct an independent investigation on behalf of SDCERS. Pursuant to the Board's authorization, the Board's special fiduciary counsel, Reish Luftman, engaged Navigant Consulting (i) to perform an investigation of allegations of illegal or wrongful acts and/or other improprieties that may have occurred with respect to SDCERS and (ii) to report on those facts and perform analysis to assist counsel in determining whether any illegal or wrongful acts had occurred. It is important to note that Navigant Consulting was not engaged to render a legal conclusion or make any determinations of law⁷

⁵ See Section VI.C.1 for additional information regarding the composition of the Board members.

⁶ The June 30, 2004 actuarial valuation is the most recent available valuation. The valuation reports typically are issued by the System's actuary the year following the valuation date (e.g. the June 30, 2004 valuation report is dated January 14, 2005).

⁷ The word "laws," as used in the definition of "illegal or wrongful acts" herein, includes the following: (i) the City of San Diego Charter; (ii) the City of San Diego Municipal Code; (iii) the California Constitution and statutes; (iv) other California fiduciary responsibility rules as

regarding the facts. See Attachment 2 for Navigant Consulting's engagement letter. Based on Navigant Consulting's findings and observations, Reish Luftman performed a legal analysis and developed legal conclusions regarding the alleged illegal or wrongful acts and/or other improprieties that may have occurred with respect to SDCERS. Reish Luftman's analysis conclusions can be found in the section of the report prepared by Reish Luftman.

Navigant Consulting was specifically asked to investigate the facts in order to assist legal counsel in concluding whether the Board of SDCERS, in its administration of the System and/or management of its assets, violated any laws resulting in a material impact on the financial status⁸ of the System. Navigant Consulting was also asked to investigate the adequacy of the funding of SDCERS.

The initial scope of the investigation was contemplated to cover the activities of SDCERS related to the City during the period January 1, 1995 through December 31, 2002. However, if facts were disclosed that warrant investigation into additional years, the scope of investigation would be expanded to include such additional years. This time period was later expanded based on Navigant Consulting's conclusion that the investigation should include the changes that impacted the City's contribution rate as early as 1991 and certain events that occurred subsequent to 2002.

Navigant Consulting was provided with six questions formulated by the SDCERS' Board with the assistance of SDCERS' litigation counsel, Seltzer Caplan, and the Board's special fiduciary counsel, Reish Luftman, to be addressed during the course of the investigation.

Questions Provided by Seltzer Caplan

1. Were any illegal acts committed regarding the methodology for calculating employer contributions by the City of San Diego at any time from 1995 to the present?
2. If so, have sufficient actions been taken to cure the effect of such acts?
3. What further actions, if any, are necessary to cure the effect of such acts?
4. Is SDCERS' current method of calculating employer contributions in conformity with generally accepted actuarial practices?
5. Has SDCERS made proper disclosures in its Comprehensive Annual Financial Reports of all relevant information regarding the actuarial soundness of the Retirement System?

established by courts and common law; (v) Federal and state securities laws and related regulations; and (vi) any guidance interpreting items (i) through (v), above

⁸ Also referred to as the "funded ratio" or "funded status" of the System.

6. Has SDCERS provided benefits to its members and their beneficiaries in conformity with all System and trust documents as contained in the applicable law?

Questions 1, 2, 3 and 6 are addressed in the section of the report prepared by Reish Luftman. Questions 4 and 5 are addressed in Sections VII.G and X, respectively.

As Navigant Consulting developed its workplan (see Attachment 3 for detailed explanation), it expanded the areas to include in its investigation.

The investigation performed by Navigant Consulting focused on the actions of the SDCERS' Board members and the SDCERS' Staff during the time period under investigation. As a result, Navigant Consulting's investigation focused on the information available from the SDCERS' office and interviews of the individuals directly associated with the decisions made by the SDCERS' Board and Staff. Navigant Consulting's investigation did not include investigating the actions of City personnel other than those acting in a capacity related to SDCERS. Therefore, Navigant Consulting did not obtain copies of all the documents produced by the City in connection with any subpoena and did not investigate the City's disclosures in its financial statements and bond offering documents.

IV. Summary of Findings and Conclusions

1. Although SDCERS is currently underfunded and the funded ratio has been declining, the System has sufficient assets to pay benefits due to all current retirees.
2. SDCERS' investment portfolio has historically generated strong returns. This performance prevented the System from being in worse financial condition due to the City's underfunding of SDCERS, but may have been a factor in the City's requests for contribution reductions and the Board's willingness to agree to those reductions.
3. The City has sought alternatives to reduce its contributions to SDCERS since at least as early as 1991.
4. The City contributed less than the Actuarial Required Contribution resulting in the underfunding of SDCERS since at least as early as 1996. The City has not made up for contribution shortfalls from previous years.
5. MP1 and MP2 did not make economic or actuarial sense because the agreements decreased the City's contributions to SDCERS at the same time the City granted more costly retirement benefits to City employees.

6. The City and SDCERS relied upon Surplus Undistributed Earnings to pay certain ongoing benefits and administrative expenses, which contributed to the underfunding of SDCERS.
7. The SDCERS' Board approved MP1 and MP2 despite concerns raised by Board members, the Board's fiduciary counsel and the System's actuary.
8. Although the Board received a recommendation from fiduciary counsel in connection with MP1 that it consider the City's financial condition and ability to pay, it did not take appropriate steps to evaluate the City's ability to fund the contribution shortfalls in the future. During consideration of MP2, the Board did not evaluate the City's ability to pay the future contribution increases.
9. Some Board members served dual roles as System members who received SDCERS' benefits, union designees who represented the union members or City employees with responsibilities to City management or City officials. The current Board structure has somewhat alleviated this problem since a majority of the Board members are not System members.
10. The SDCERS' Staff assisted the City in developing and implementing alternatives to reduce the City's contributions to SDCERS.
11. The SDCERS' fiduciary counsel and actuary could have more clearly explained their concerns to the Board and could have been more forthcoming in stating a position with regard to both MP1 and MP2.
12. SDCERS engaged different fiduciary counsel on at least four separate occasions to evaluate each of the City's contribution reduction requests. Due to the complexity of the System and the City's requests for decreased funding, continuity in fiduciary counsel may have resulted in better informed advice and better communication to the Board.
13. The SDCERS' Comprehensive Annual Financial Report contained misleading and/or omitted disclosures regarding the funding of the System.
14. The annual actuarial valuations prepared for SDCERS contained misleading statements about the funding objectives and practices.
15. The SDCERS' Board requested that the actuarial valuation exclude the benefits granted to retirees in connection with the Corbett settlement.

16. SDCERS' tax counsel identified technical violations of IRS regulations governing retirement plans related to presidential leave benefits.

V. Sources of Information, Processes Employed and Interviews Conducted

A. Processes Employed

1. Developed Workplan

To develop its workplan, Navigant Consulting conducted preliminary interviews of the SDCERS' executive staff, SDCERS' litigation counsel, Seltzer Caplan, and special fiduciary counsel to the SDCERS' Board, Reish Luftman. Navigant Consulting also reviewed documents from prior investigations, including the current City Attorney and V&E reports. Upon completion of the workplan and approval by Reish Luftman, Navigant Consulting shared the workplan with Seltzer Caplan, SDCERS' Administrator Lawrence Grissom and General Counsel Loraine Chapin and each of the Board members who were serving terms in September 2005 (except for John Torres who declined to be interviewed), to identify any additional items to include in the workplan. No workplan steps were removed as a result of these discussions. Throughout the course of the investigation, Navigant Consulting continued to refine the workplan based on information learned. See Attachment 3 for the final workplan, including the interview list.

2. Interactions with the Board

At the request of Reish Luftman, pursuant to the request of Peter Preovolos, SDCERS' current Board President, Navigant Consulting did not communicate the status of its work or any preliminary findings or conclusions to the Board. During the investigation, Reish Luftman served as the liaison between the Board and Navigant Consulting. At the Board's request, Navigant Consulting did not provide any preliminary drafts of the report to Board members.⁹ The Board members will receive the report for the first time on January 20, 2006. As a result, Navigant Consulting's investigation was independent of any influence by the current SDCERS' Board.

Upon reading the report, the Board may request additional analysis or further investigation. In the event that additional facts are identified and investigated, this report may be modified or supplemented.

⁹ Also at the request of Reish, Luftman, Reicher & Cohen and the SDCERS' Board of Administration President, Navigant Consulting did not share the findings and conclusions in this report with any of the SDCERS' staff prior to issuing the report.

3. Conducted Interviews

As part of the workplan, Navigant Consulting initially identified approximately 75 people to interview. During the course of the investigation, Navigant Consulting modified the list resulting in approximately 90 people to be interviewed. See Attachment 4 for a list of these individuals. As Navigant Consulting endeavored to arrange interviews with these individuals, Navigant Consulting learned that many of the individuals were represented by counsel. Some of the people declined to be interviewed by Navigant Consulting. Some allowed Navigant Consulting to conduct an interview but limited the amount of time allowed for the interview. Some agreed to answer written questions or have their counsel respond to written questions. Most of the individuals interviewed had done so in other investigations as well. Out of the total number of people to be interviewed, Navigant Consulting conducted interviews or received responses to written questions from approximately 50 individuals. Some of the individuals were interviewed on multiple occasions.

4. Reviewed Documents

a. Seltzer Caplan McMahon Vitek Database

Navigant Consulting received and reviewed documents contained in an electronic database provided by Seltzer Caplan. Navigant Consulting understands that Seltzer Caplan was responsible for the collection and maintenance of this database which contained all documents collected in response to subpoenas from the SEC and U.S. Attorney's Office. This database included approximately 180,000 documents and totaled approximately 354,000 pages. Navigant Consulting also conducted certain procedures to ensure that it received an exact replica of the Seltzer Caplan database.

This database also included certain documents that Seltzer Caplan had previously deemed privileged communications. In a Special Board meeting on August 30, 2005, the Board voted to provide previously unreleased documents to the investigative agencies who had subpoenaed SDCERS, including the U.S. Attorney, the SEC and the San Diego County District Attorney. The Board also voted to provide these documents to Kroll.

Based upon Navigant Consulting's workplan, procedures and understanding of the investigation, Navigant Consulting compiled a list of 127 search terms and filtered the above electronic database utilizing these search terms. See Attachment 5 for a list of those search terms. This search resulted in a total of approximately 111,000 documents that Navigant Consulting reviewed. After several levels of review, the documents of interest were summarized and included in interview outlines and document summaries for the respective individuals.

With respect to the previously privileged documents, Navigant Consulting reviewed all of these documents in their entirety.

b. Hard Drive Images

In November 2005, Navigant Consulting imaged fifteen hard drives from twelve individuals from SDCERS, including General Counsel's office, Executive Staff and their administrative assistants.¹⁰ Prior to imaging the hard drives, Navigant Consulting informed the SDCERS' Staff to separate any potentially privileged documents related to representation by their own counsel or ongoing litigations. Seltzer Caplan provided a list of the ongoing litigation to SDCERS as a reference. Navigant Consulting applied the list of search terms to the imaged hard drive and also identified any previously deleted emails and documents. From this imaging process, Navigant Consulting collected and reviewed approximately 23,000 additional electronic documents.

c. Other Documents

In addition to the electronic documents described above, Navigant Consulting reviewed documents collected from other sources. The documents include, among other things, the reports from earlier investigations and litigation concerning SDCERS as discussed later in the report, SDCERS' Comprehensive Annual Financial Reports ("CAFR[s]"), the annual actuarial valuations prepared by SDCERS' actuary, the City's internal audit reports of SDCERS, personnel files of selected SDCERS Staff,¹¹ available preliminary hearing transcripts for the *People of California v. Cathy Lexin, et al.*¹², and deposition transcripts from *James F. Gleason and David W. Wood v. San Diego City Employees' Retirement System and City of San Diego, et al.*

¹⁰ The twelve selected SDCERS' Staff include Larry Grissom (Retirement Administrator), Loraine Chapin (General Counsel), Roxanne Story Parks (Assistant General Counsel), Sheila Leone Jacobs (Assistant General Counsel), Doug McCalla (Chief Investment Officer), Patrick Lane (Chief Financial Officer), David Arce (Operations Division Manager), Dawn Clarke (Assistant Chief Investment Officer), Cynthia Hilliard (Assistant to Larry Grissom), Donna Hawthorne (Board Secretary), and Dawn McHorney (General Counsel Secretary).

¹¹ Navigant reviewed personnel files of Larry Grissom (Retirement Administrator), Paul Barnett (former Assistant Retirement Administrator), Loraine Chapin (General Counsel), David Arce (Operations Division Manager), Doug McCalla (Chief Investment Officer), Patrick Lane (Chief Financial Officer), and Vincent Hayes, Jr. (former Training and Marketing Division Manager).

¹² As of the writing of this report, Navigant Consulting had received the first eleven days of the preliminary hearing transcripts, most of which were received on January 13, 2006. Since the report was issued to the Board on January 20, 2006, not all testimony at the preliminary hearing has been considered in this report.

5. Consulted with Actuarial Consultants

Reish Luftman also engaged the Hay Group and Stephen H. Rosen & Associates to provide actuarial analysis and advice for the investigation. The actuaries reviewed all of the pertinent actuarial reports, CAFRs, and related materials, such as Board presentations by the actuary, to determine how the reports and other presentations conformed to actuarial standards and practices. The actuaries analyzed the changes in the unfunded liability from 1996 through 2004. It is important to note that the Hay Group and Stephen H. Rosen & Associates were not engaged to render legal conclusions or make any determinations of law regarding the facts.

6. Consulted with Investigative Counsel

Late in the investigation, Reish Luftman engaged McDermott, Will & Emery LLP which advised the engagement team regarding investigative protocol, certain areas of legal research and investigative report preparation.

7. Consulted with Employment Law Counsel

In response to several specific matters that arose during the course of the investigation, Reish Luftman engaged Littler Mendelson P.C. to advise them regarding employment law issues.

B. Other Investigations and Reviews of SDCERS and the City's Funding

There is a wealth of information concerning the issues involved in the investigation, either publicly available in the normal course of City or SDCERS' business or made available as part of the litigation and investigations which have occurred over the last several years. During the course of its investigation, Navigant Consulting reviewed some of this information. The summary that follows briefly describes the information that Navigant Consulting reviewed from earlier investigations and litigation concerning SDCERS.

1. The Mayor's Blue Ribbon Committee Report

In 2001, the Mayor of San Diego created the Blue Ribbon Committee on City Finances to, among other things; evaluate the fiscal health of the City. The Committee identified concerns regarding the funding of the Retirement System and health care benefits. The Committee issued its report in February 2002. Although the Committee raised concerns about the underfunding of the Retirement System, the City and SDCERS agreed to changes in the City's contribution rate in November 2002 which continued the underfunding. Although the City requested that SDCERS respond to the Committee's

report in mid-2002, SDCERS responded to the City regarding the retirement items in February 2003. SDCERS' presentation to the City on February 13, 2003 explained that the declining investment market and changes in benefits impacted the funding level of SDCERS.

2. Public Financial Management Draft Report

In April 2003, the City received a preliminary report from Public Financial Management ("PFM"), which assessed alternatives to increase SDCERS' funding. The preliminary report specifically presented PFM's "analysis to outline certain factors that the City might wish to consider as it contemplates a potential restructuring and/or refinancing of the City's existing and projected pension liabilities, including... the Unfunded Actuarial Accrued Liabilities ("UAAL"). PFM identified several funding scenarios, including the City issuing pension obligation bonds. The emphasis of PFM's analysis appeared to be focused on identifying ways to minimize the City's contributions to SDCERS in the near term. The report included projections of contribution amounts and the impact on the funded ratio through 2021. These projections showed that under each of the scenarios, including the issuance of \$720 million of pension obligation bonds, the City faced escalating contributions that would be in excess of \$100 million by 2004 and \$200 million by 2008. Navigant Consulting obtained a copy of the draft PFM report during one of its interviews. Navigant Consulting does not know the outcome of the work performed by PFM, any actions taken by the City in connection with those recommendations or if the report was finalized.

3. Pension Reform Committee Report

In July 2003, in response to the recommendations from the Blue Ribbon Committee, the Mayor established the Pension Reform Committee which was officially created by resolution of the City Council in September 2003. The Committee consisted of nine members, one of whom was a member of the SDCERS' Board. The Committee's charge included the following:

- Provide recommendations to address any unfunded liability problems of the System.
- Examine how the existing pension System has performed compared to other similar systems, including examination of actions other systems have taken to address funding shortfall problems, such as issuance of pension obligation bonds.
- Examine whether changes should be made to the existing pension system.
- Examine whether the make-up and representative constitution of the Retirement Board should be restructured.
- Examine whether the system should be changed from a defined benefit plan to a defined contribution plan for new employees.

- Examine whether the City should join the California Public Employees Retirement System or any other retirement system.
- Make other recommendations as appropriate.

The Committee's report, issued in September 2004, recommended that the City increase the funding to SDCERS by \$600 million over three years through the issuance of pension obligation bonds or real estate secured transactions. The Committee also recommended a reduction in the amortization period which increased the City's annual contribution. The report also included recommendations regarding retiree health insurance, specifically that retiree health care costs should not be funded through SDCERS. The City did not adopt these recommendations or several other items included in the report. In response to the Committee's report, voters approved changes to the composition of the Board to include a larger number of independent (i.e., non-city employee) members.

4. Vinson & Elkins L.L.P.

V&E was engaged by the City and the details of its report and memorandum provided to the City are described below.

a. Report on Investigation Dated September 16, 2004

V&E was retained by the City of San Diego on February 11, 2004, to assess whether the City had failed to meet its disclosure obligations under the federal securities law relative to the funding of SDCERS for the period 1996-2004. This V&E report was dated September 16, 2004. Navigant Consulting obtained this report from the City of San Diego's website. Although V&E's focus was centered on the City's possible disclosure deficiencies, to the extent, that the SDCERS' Board played a role directly or indirectly, Navigant Consulting undertook the review of this report to assess V&E's findings and consider the potential impact on its procedures.

V&E made a number of observations, findings, and recommendations relative to the City. V&E also included commentary regarding the SDCERS' Board as well as the SDCERS' Staff, including:

1. The SDCERS' Board acquiesced to the City by allowing the City to decrease its funding of SDCERS primarily through the execution and adoption of MP1 and MP2.
2. The additional retirement benefits that the City was providing to union employees in connection with MP1 and MP2 were contingent upon the agreement of the SDCERS' Board.
3. The SDCERS' Staff participated in drafting MP1.

4. In the Fall of 2001, the SDCERS' Staff was aware that the funding status of SDCERS was deteriorating and the triggering provisions for a balloon payment by the City were likely to occur.
5. V&E explicitly noted that it was beyond the scope of its report to comment on the Board's failures or culpability with respect to its decisions regarding MP2.
6. SDCERS was making more comprehensive disclosures in its CAFRs than the City relating to MP1 and other changes to the System from fiscal year 2000 and forward; however, SDCERS' CAFRs still contained inaccuracies.

Navigant Consulting considered V&E's findings and conclusions relative to the SDCERS' Board and its staff during Navigant Consulting's work. To the extent possible, Navigant Consulting performed procedures to analyze and assess these findings and conclusions. These findings are consistent with Navigant Consulting's findings.

Reish Luftman requested copies of V&E's interview memos for many of the individuals Navigant Consulting endeavored to interview. As of January 20, 2006, Reish Luftman had not received copies of those memos.

b. Draft Memoranda Dated July 15, 2005

V&E also issued a follow-up draft memorandum dated July 15, 2005. Navigant Consulting obtained this document from SDCERS' Staff during the course of its investigation. Navigant Consulting considered the information noting that it was labeled "for discussion purposes only; may contain errors".

5. City Attorney Michael Aguirre Interim Reports and Related Exhibits

Navigant Consulting reviewed seven interim reports issued by the San Diego City Attorney, Michael Aguirre, as well as the referenced exhibits contained within the interim reports. These reports and exhibits were obtained from the City Attorney's website. The focus of Navigant Consulting's review related to the actions and events of SDCERS and its Board members. Navigant Consulting used these interim reports to assist in developing and executing its workplan.

6. Securities and Exchange Commission and the Department of Justice Investigations

The SEC began its investigation of the City's disclosure practices relative to the City's funding of SDCERS in February 2004. Concurrently, DOJ's investigation began and it appears to overlap with the SEC's investigation. On January 6, 2005, the U.S. Attorney indicted five individuals, including three former Board members, the former SDCERS'

Administrator and current SDCERS' General Counsel. These investigations are ongoing. Navigant Consulting has not been made aware of any of their other conclusions relative to the SDCERS' Board or members of the SDCERS' Staff. Further, Navigant Consulting has had no discussions with the SEC or DOJ regarding their findings or conclusions.

7. County of San Diego District Attorney Investigation

The County of San Diego District Attorney began an investigation during June 2004. As a result of this eleven-month investigation, on May 17, 2005, the District Attorney for the County of San Diego, Bonnie Dumanis, announced the indictment of six former Board members¹³ and charged them with felony conflict of interest. The charges alleged stemmed from violations of California's Government Code Section 1090. The allegations include that the Board members endorsement and adoption of MP2 was a personal benefit to them and this created a conflict of interest. The preliminary hearing for the indicted Board members began in December 2005. Navigant Consulting obtained copies of the preliminary hearing transcripts as they were made available by the court reporter. As of the date of this report, Navigant Consulting received the first eleven days of testimony. On January 13, 2006, the Superior Court judge ruled that there is sufficient evidence to try the six former SDCERS' Board members on a single felony conflict-of-interest charge.

8. Kroll, Inc.

In February 2005, the City entered into an agreement with Kroll¹⁴ to receive, review and evaluate the findings of the investigations performed by V&E and the City Attorney and to provide consulting assistance in assessing internal control deficiencies affecting matters discussed in the investigation reports. Navigant Consulting understands that Kroll's investigation is estimated to be completed in 2006.

¹³ The indicted Board members include Ron Saathoff, Cathy Lexin, Sharon Wilkinson, Mary Vattimo, John Torres and Terri Webster.

¹⁴ There have been published reports and questions posed to Navigant Consulting during interviews about an affiliation between Kroll and Navigant Consulting. These are two separate companies with no affiliation. Navigant Consulting is an independent, publicly traded company (NYSE: NCI). Kroll is a subsidiary of Marsh & McLennan Companies, Inc. (NYSE: MMC). There have also been published reports that Navigant Consulting is serving as the Audit Committee for SDCERS, which is untrue.

9. Other SDCERS' Consultants

a. Actuarial and Operational Reviews

Pursuant to the San Diego Municipal Code, the Board conducts an actuarial investigation of the mortality, service and compensation experience of members and persons receiving benefits, together with an actuarial valuation of the assets and liabilities (known as "experience investigations") of the Retirement System every five years.

In addition, the Board hired Milliman & Robertson, Inc. in 1999¹⁵ to conduct an audit of actuarial work previously completed by SDCERS' actuarial consultants, Gabriel Roeder Smith ("GRS"). The Board also hired William M. Mercer, Inc, ("Mercer") to conduct an audit of actuarial work¹⁶ and additional reviews in 2004¹⁷. The details of this work are discussed in Section IX.E.5.

At the direction of the Board, Mercer conducted interviews regarding Board independence and reported draft findings to the Board on July 16, 1999. Navigant Consulting is not aware if Mercer finalized this report. Mercer interviewed both Board members and SDCERS' Staff among others. Mercer included several observations, including:

- There were concerns expressed that the City employees who were on the Board felt pressured to vote in favor of the City.
- There were concerns that Board members were voting for the benefit of the labor unions rather than for the benefit of SDCERS.
- There appeared to be some confusion as to what responsibilities the Board had to the City.
- There were concerns that recently enacted benefit increases were beyond "sound economics".

¹⁵ June 10, 1999 SDCERS' Actuarial Audit

¹⁶ May 11, 2004 Mercer Report - Audit of Actuarial Work - Mercer Human Resources Consulting

¹⁷ The following reports were issued by Mercer in 2004:

- May 11, 2004 - Federal Law Compliance Diagnostic Review - Mercer Investment and Human Resource Consulting
- May 18, 2004 - Custodian Evaluation - Mercer Investment Consulting
- May 18, 2004 - Investment Operations Audit - Mercer Investment Consulting
- May 20, 2004 - Audit Reports
- June 17, 2004 - Audit Reports: Custodian Evaluation Report and Investment Operations Audit Report
- November 18, 2004 - Best Practices Reports

b. Investment Consultants and SDCERS' Investment Performance

i. Callan Associates, Inc.

Callan Associates, Inc. ("Callan"), investment advisors to SDCERS,¹⁸ regularly evaluated SDCERS' liabilities, contributions, and potential earnings in order to assess alternative investment strategies. Callan concluded in its August 29, 2003 letter to SDCERS' Administrator, Mr. Grissom, the following:

- "SDCERS' total fund has outperformed the median public pension plan in the Callan database for the past two fiscal years."
- "Over the last five years, SDCERS' annualized total fund return of +5.21% ranks in the 5th percentile of public pension plans in the Callan database, with a return of 100 basis points ahead of the policy benchmark."
- "The fiscal years ended June 30, 2003 and 2002, were characterized by unpredictability in the global markets, equity and fixed income alike. However, SDCERS' disciplined and diversified investment approach over the last two years has led to excellent relative performance, ranking the total fund in the 14th percentile in FY 2002 and the 25th percentile in FY 2003 when compared to the Callan public pension plan total fund database."

ii. Wilshire Associates, Inc.

Wilshire Associates conducted research on state retirement systems and issued its findings on March 10, 2005 in a report titled "2005 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation." This report focused its research on the change in assets, liabilities, funding ratios, and Unfunded Actuarial Accrued Liability ("UAAL") for 125 state retirement systems, 64 of which reported actuarial values on or after June 30, 2004. In a study on these 64 retirement systems, Wilshire stated:

- "Market value funding ratios fell dramatically between 2000 and 2002, from 112% to 81%, and have remained flat over the last three years. Actuarial value funding ratios declined steadily over the last five years, from 103% in 2000 to 85% in 2004."

¹⁸ SDCERS' investments are actively managed. This investment strategy served SDCERS well during the years of poor market performance. James Callahan of Callan & Associates said that SDCERS may have used the investment strategy to increase the amount of realized gains to yield a greater amount of surplus undistributed earnings.

- It is also shown that of the 64 state pension systems, 84% (or 54 pension systems) have assets less than liabilities, and thus, are underfunded.

iii. Mercer Investment Consulting

Mercer performed an investment operations audit and issued a report in May 2004. Mercer concluded, among other things, the following:

- The investment program had delivered superior performance over the long-term period under review compared to similar public retirement systems.
- The staff demonstrated a high level of knowledge and expertise regarding the investment industry as well as how the investment program integrates with the overall purposes of the System.
- SDCERS has exemplary investment data accuracy validation systems.

In 2004, Mercer also performed a custodian evaluation and issued a report in May 2004. Mercer concluded in its report that “the reconciliation procedures appear effective and exceed the standard of care employed by most pension funds similar to SDCERS in size and complexity.”

iv. Observations Regarding SDCERS’ Investments
from Navigant Consulting’s Investigation

During the course of the investigation, Navigant Consulting noted that SDCERS’ internal controls over its investment portfolio were consistent with the types of controls typically associated with investments. Navigant Consulting did not conduct a test of SDCERS’ internal controls or conduct an audit of SDCERS’ financial statements.

The SDCERS’ Chief Investment Officer oversees the investment process with active involvement by the SDCERS’ Board. SDCERS’ investments are held by a custodian bank, State Street Bank and Trust Company (“State Street”). State Street holds the assets and executes the trades, but does not make any investment decisions. SDCERS uses approximately twenty-six outside money managers, who are selected by the SDCERS’ Chief Investment Officer and approved by the Board. The money managers initiate SDCERS’ investment transactions. Callan serves as SDCERS’ independent investment consultant and evaluates SDCERS’ performance in relation to market indices, appropriate manager peer groups, and other public funds. SDCERS’ investment division maintains internal records of investment activities which it reconciles to reports from State Street, investment managers and Callan.

Navigant Consulting obtained the investment schedules and third party documentation SDCERS had previously provided to SDCERS’ outside auditor, Brown, Armstrong, Paulden, McCown, Starbuck & Keeter (“Brown Armstrong”) in connection with the

audit in order to test the accuracy of the System's investments at June 30, 2004. Brown Armstrong included two comments regarding SDCERS' investments, neither of which was a material weakness, in its May 2005 Communication of Reportable Conditions to the Retirement Board and Management.¹⁹

SDCERS provided Navigant Consulting with the June 30, 2004 statement from State Street, SDCERS' internal statement of the investments at cost, SDCERS' reconciliation of the differences between the State Street statement and the internal statement and the schedule of investments included in the 2004 draft Comprehensive Annual Financial Report ("CAFR"). Based on Navigant Consulting's review of the information, the \$2.9 billion of investments reported in the draft 2004 CAFR was supported.

10. Other Information that May Exist

Navigant Consulting conducted its investigation during a five month period, commencing at the end of August 2005 and culminating with this report on January 20, 2006. During that time, the preliminary hearing began in the District Attorney's criminal case against several of the former Board members, the City Attorney issued at least one additional interim report of findings, the SDCERS' Administrator and General Counsel were indicted by a federal grand jury, the citizens of San Diego elected a new mayor who will be addressing the City's finances and pension reform and the Kroll investigation for the City continues. Navigant Consulting was unable to interview all individuals on its interview list, some of whom were interviewed by investigators with subpoena power. There may be additional information that has been uncovered, or will arise, by others in any of these actions and investigations that may impact the findings and conclusions in this report.

VI. SDCERS' Structure and Operations

A. SDCERS' Structure

The City of San Diego established SDCERS in 1927 in accordance with the California State Constitution Article XVI, Section 17, the San Diego City Charter, Article IX Sections 141-149 and Article X, Section 1 and the San Diego Municipal Code Sections 24.0100 – 24.1809. SDCERS provides retirement, disability and death benefits to its members. It also administers a health insurance benefit for eligible retirees. SDCERS is a defined benefit plan, covering the City of San Diego, the Unified Port of San Diego ("Port") and San Diego County Regional Airport Authority ("Airport Authority").²⁰ SDCERS consists

¹⁹ The comments related to the lack of reconciliations of (i) asset movement between money managers and (ii) market and cost of investments to the custodian.

²⁰ The assets for the City, the Port and the Airport are commingled for investment purposes. There is separate accounting, funding and benefit administration for each of the three entities.

of active members, including General members, Safety members and Elected officials, and retired members.

Both the City (the employer contribution) and the employee (the employee contribution) contribute a percentage based upon the employees' salaries to SDCERS. Over the years, the City has agreed to pay a portion of the employee contribution in connection with agreements reached with the employee unions.²¹ The City Charter allows for certain reserves, including the employer contribution rate reserve, to be established from Surplus Undistributed Earnings.

Pursuant to City Charter, the City establishes the benefits for SDCERS' members. The City and its unions negotiate employee compensation and benefits during the meet and confer process which occurs before the expiration of each contract, or "MOU" (Memorandum of Understanding).²² Until 2005, the City negotiated with four unions – Police Officer Association ("POA"), Firefighters Local 145 ("Local 145"), Municipal Employee Association ("MEA") and Local 127.²³ The employees of each union receive different benefits based upon their applicable MOUs. The benefits are subject to approval by the City Council. SDCERS does not establish the employee benefits; SDCERS has responsibility for administering the benefits established by the City.

In addition to its responsibility for administering the benefits, SDCERS, and specifically the Board, have actuarial, investment and administrative responsibilities as set forth in the City Charter and Municipal Code and as explained in its Board Rules. As part of its actuarial and administrative responsibilities, the Board oversees the employer's contribution to the System to adequately fund members' benefits.

SDCERS employs outside firms or advisors to assist in performing its duties. To select those firms, SDCERS follows the City's Request for Proposal ("RFP") process to hire outside counsel, including fiduciary, litigation and tax counsel, an actuarial firm and an investment consultant. Beginning with the fiscal year 2004 financial statements, SDCERS hired its own independent auditor.²⁴ The Board also has responsibility for hiring investment managers.

There have been no allegations regarding the Port and Airport contributions since the contributions are based on the actuarial calculations. As a result, Navigant Consulting's investigation focused only on the City.

²¹ Known as "pick up" in the actuarial valuation reports.

²² The labor agreements have been single and multi-year agreements.

²³ The City Attorney's office formed its own union after Michael Aguirre became the City Attorney in November 2004.

²⁴ In prior years, the City's outside auditor audited the SDCERS' financial statements.

B. Complexity of SDCERS' Benefits

SDCERS administers retirement benefits for three distinct organizations: the City of San Diego, the Unified Port of San Diego ("Port"), and the San Diego County Regional Airport Authority ("Airport Authority").²⁵ Within each of these groups, employees receiving benefits are categorized as General Members or Safety Members (police, fire and lifeguard). The City has an additional categorization of Elected Official Members. Some General Members of the City are members of Local 127 and MEA. The remaining General Members are considered Unclassified. Each of these classifications of employees in the City, Port, or Airport Authority may receive different retirement benefits depending on variables such as age, age at retirement, salary, and choice of benefit factors, among others. Additionally, benefits for employees within a classification may differ. For example, retirement factors for lifeguard safety are different than those for police and fire safety (as stipulated in the 1996 City Manager's proposal). Retirement benefits may change with each meet and confer process.

Other variables add to the complexity of retirement benefit determinations. With the benefits granted as a result of the Corbett settlement,²⁶ City General and Safety members have the option to elect the Corbett retirement factors or the pre-Corbett retirement factors. Starting July 1, 2002, General and Safety members are also subject to a 90% cap to their benefits while Elected Official members are not. These caps were previously not in place. Despite the cap, there were allowances made to exceed the cap under certain circumstances (see Section VII.F.10). Additionally, cost-of-living adjustments ("COLA") were made to members of Local 127, Local 145 and the POA, increasing it from 1.5% to 2% per year for retirees who retired before October 6, 1980. This change was effective retroactive to July 1, 1992. These are only a few highlighted examples of differences in benefits that demonstrate the intricacies of benefit administration.

During its investigation, Navigant Consulting developed an understanding of SDCERS' operations, including the complexity of the benefit structure. However, Navigant Consulting did not conduct an audit of SDCERS' operations or test the accuracy of SDCERS' benefit payment calculations since it was outside the scope of Navigant Consulting's investigation.

²⁵ Navigant Consulting's investigation focused on the City, not the Port Authority or Airport Authority. Navigant Consulting's analyses of SDCERS or the actuarial valuations related to the City only.

²⁶ In July 1998, a class action lawsuit was filed against SDCERS alleging that retirement benefits were not properly calculated. *Corbett v. City Employee Retirement System* (San Diego Super. Ct.) (No. 722449)

C. SDCERS' Board of Administration

1. Board Composition

The SDCERS' Board of Administration ("Board") is composed of thirteen members as mandated by the City Charter, Article IX, Section 144 and Article X. In November 2004, in response to recommendations made by the Pension Reform Committee, the composition of the Board was changed through the enactment of Proposition H by the San Diego voters, which amended Section 144 of the City Charter. The Board maintained its thirteen members, but allocated those seats differently among the members by providing the majority membership to appointees.

Historically, the members of the Board consisted of nine elected members (three ex-officio members and six City representatives) and four appointees. Effective April 1, 2005, the Board changed its composition to six elected members (one ex-officio and five elected representatives) and seven members appointed by the Mayor and confirmed by the City Council. The six elected representatives have been limited to two general members and one representative each from the City Manager's office, retirees, police union and fire union. The seven appointees are to have a financial background and no personal financial interest in the retirement system. The members now serve four-year terms with a two-year term limit, except for the inaugural police safety and retiree members elected in 2005 who shall serve a two-year term.

The following table summarizes the Board's composition before and after Proposition H:

<i>Before-Proposition H</i>	<i>After-Proposition H (Effective April 1, 2005)</i>
Ex-Officio Members – 3 One City Manager Designee One City Auditor and Comptroller One City Treasurer	Ex-Officio Members – 1 One City Manager Designee (City Manager, City Treasurer, Deputy or Assistant Manager, or person in similar position who reports to the City Manager)
Member Elected Representatives – 6 Three Elected General Members One Elected Police Safety Member One Elected Fire Safety Member One Elected Retiree Member	Member Elected Representatives – 5 Two Elected General Members One Elected Police Safety Member One Elected Fire Safety Member One Elected Retiree Member
Appointees – 4 One Officer of a Local Bank Three Other Citizens (appointed by the City Council)	Appointees – 7 Seven Citizens (appointed by the Mayor and confirmed by the City Council)
Total = 13 Members	Total = 13 Members

2. Board Members

Prior to the enactment of Proposition H, nine of the thirteen Board members were current or former City employees. Representatives from the City occupied three seats, the general members occupied three seats, the safety members occupied two seats and the retirees occupied one seat. The ex-officio members served the period of their respective positions and the remaining members served six years or until their successors were elected and qualified. Board members serve on a volunteer basis and are not compensated for their services. To carry out any motion or authorize any action, a vote of seven members was necessary to constitute a quorum. Attachment 6 represents a timeline of when the Board members served from 1995 through 2004.

During the negotiations and approval of MP1 in 1996 and MP2 in 2002, the members who served on the Board were, as follows:

Representative	MP1	MP2
City Manager	Bruce Herring <i>Deputy City Manager</i>	Cathy Lexin <i>City Labor Relations Manager</i>
City Auditor	Terri Webster <i>Ass't. City Auditor/Comptroller</i>	Terri Webster <i>Ass't. City Auditor/Comptroller</i>
City Treasurer	Conny Jamison <i>City Treasurer</i>	Mary Vattimo <i>City Treasurer</i>
General Member	John Casey <i>City Planning & Development</i>	John Casey <i>City Planning & Development</i>
General Member	John Torres <i>San Diego Police Department, Forensics</i>	John Torres <i>San Diego Police Department, Forensics</i>
General Member	Sharon Wilkinson <i>Qualcomm Stadium</i>	Sharon Wilkinson <i>Qualcomm Stadium</i>
Police Safety Member	Keith Enerson (President) <i>President of the Retired Fire and Police Association</i>	Tom Rhodes <i>Senior Member of POA Board</i>
Fire Safety Member	Ron Saathoff <i>President of City Firefighters Local 145</i>	Ron Saathoff <i>President of City Firefighters Local 145</i>
Retiree Member	Jack Katz <i>Retired, Former Head Deputy City Attorney</i>	David Crow <i>President of Retirement Committee</i>
Appointee Banker	Paul Barnett <i>Wells Fargo Bank</i>	Ray Garnica <i>United California Bank</i>
Appointee Citizen	Ann Parode <i>Attorney</i>	Diann Shipione <i>UBS/Paine Webber</i>
Appointee Citizen	Robert Scannell <i>R.S. Consulting</i>	Richard Vortmann <i>National Steel & Shipbuilding Co.</i>
Appointee Citizen	Vacant	Frederick Pierce (President) <i>The Pierce Company</i>

3. Tenure of Board Members

At the time of MP1 and MP2, the City representatives on the Board had served long tenures as discussed below:

a. City-elected Officials

The City Manager's office was represented by Mr. Herring during MP1 and Ms. Lexin during MP2. Mr. Herring served on the Board from January 1996 through December 2000, and was then replaced by Ms. Lexin in January 2001. Ms. Lexin also served as the City's Labor Relations Manager from 1994 through 1998.

Ms. Webster served on the Board temporarily on behalf of Ed Ryan, the former City Auditor, from July 1995 through October 1995, and became a permanent Board member beginning November 1995 until May 2005, when she was placed on administrative leave.

Ms. Jamison served on the Board for approximately 20 years through May 2001, when she was replaced by Ms. Vattimo as the City Treasurer.

b. General Member Representatives

At the time of MP1 and MP2, the general members were John Casey, Sharon Wilkinson and John Torres. Mr. Casey had been a Board member since 1988. Ms. Wilkinson served on the Board since 1992 for three consecutive terms scheduled to end in June 2008. Mr. Torres served on the Board since 1995 and has been the Vice-President of the Municipal Employees Association ("MEA") since 2000.

c. Safety Member Representatives

The police safety members were represented by Keith Enerson during MP1 and Tom Rhodes during MP2. Mr. Enerson had served on the Board since 1985 and as Board President from 1994 until June 1999, when he was succeeded by Tom Rhodes as the police safety representative. During MP1 and MP2, the fire safety members were represented by Ron Saathoff, who had served on the Board for at least 18 years, or four consecutive terms, scheduled to end in June 2009, and he has been President of Local 145 since 1980.

d. Retiree Representative

The retirees were represented by Jack Katz during MP1 and David Crow during MP2. Mr. Katz was the former Head Deputy City Attorney and served on the Board prior to 1995 through 1998, when he was replaced by Mr. Crow.

e. Appointees

During MP1, there were only three appointees: Paul Barnett, Ann Parode and Robert Scannell. Mr. Barnett was the local bank appointee and he had served on the Board

from 1994 until 2001, when he resigned and became the SDCERS' Assistant Administrator. Upon his resignation from the Board, Ray Garnica became the local bank appointee. Ms. Parode, an attorney, served from April 1996 through March 1997. She was replaced by Diann Shipione. Mr. Scannell served on the Board since 1991, and as Board President from June 1999 through January 2000. His position was filled by Richard Vortmann as the new appointee in September 2001. The fourth appointee position was vacant during MP1 and was filled in July 1997 by Frederick Pierce, who became Board President upon Mr. Scannell's resignation.

4. Board Member Roles and Responsibilities

The SDCERS' Board has the authority and fiduciary responsibility to administer the System, exclusively control the administration and investment of the SDCERS' Trust Fund, and subject to the Charter and the Municipal Code, modify benefits for service and disability and determine benefit eligibility as outlined in Article XVI, Section 17 of the California Constitution and amended by Proposition 162 (passed in 1992). These fiduciary responsibilities are owed to the System, its active and retired members, and their survivors and beneficiaries. As specified in Board Rule 1.10, as adopted on July 22, 1994, these fiduciary responsibilities include that Board members:²⁷

- Attend meetings and be fully informed and prepared to discuss issues docketed on the agenda.
- Avoid any activity which may be interpreted as a conflict of interest.
- Exercise prudence and integrity in the management of funds under supervision of the Board.

The specific duties and responsibilities of the Board are addressed in the California State Constitution, the City Charter and the City Municipal Code.²⁸ These duties and responsibilities include:

- Administration and management of SDCERS,
- Administration of benefits to participants and their beneficiaries, and
- Investment of SDCERS' Trust Fund.

The administration and management of SDCERS includes appointing a secretary and any other employees as may be necessary, determining the proper rate of interest to be earned on the Trust Fund, making necessary transfers from the reserves for member contributions and reserves for employer contributions to provide the actuarially

²⁷ Board Rule 1.10 includes additional fiduciary responsibilities.

²⁸ The specific duties and responsibilities of the Board are set forth in Article XVI, Section 17, of the State Constitution, San Diego City Charter Sections 141-149, and San Diego Municipal Code sections 24.0100-24.1809 and Board Rules 1.10-1.44.

recommended amount available for retired members and allocating each year from the Undistributed Earnings Reserve a sufficient amount to meet the budgeted expenses and costs for operating SDCERS. The administration of benefits includes providing for the normal rates of contribution and retirement allowances for its members. The investment of SDCERS' Trust Fund include the investing in funds and conducting related activities, such as actuarial valuations, experience studies and setting contribution rates. The Board may employ independent investment counselors and an actuary as needed to provide professional services to support its investment responsibilities.

As discussed above, the Board may appoint a secretary and any other employees as necessary to help facilitate its responsibilities. The secretary function may be served by the Board's appointed Administrator, who is solely responsible to the Board and has the primary role of administering Board policy. The Administrator, in turn, is responsible for and supervises the SDCERS' staff.

D. SDCERS' Staff

SDCERS' membership had grown to approximately 19,000 members as of June 30, 2003²⁹ as compared to 9,629 members as of June 30, 1995, which represents approximately 100% growth over this time period. The SDCERS' Board is responsible for administering the retirement, disability and death benefits for its members. The day-to-day operations of SDCERS are supervised by the Administrator who is hired by the Board to administer the policy set by the Board. The Administrator is responsible for all SDCERS' Staff, which consists of approximately 55 employees. Under the direction of the Administrator, the Staff implements and administers the Board policies and procedures. SDCERS' Staff is managed by the "executive" team, consisting of the Administrator, Assistant Administrator, General Counsel, Chief Investment Officer, Financial & Technical Management Division Manager and Operations Division Manager. The executive team meets each week to discuss SDCERS' issues and recommendations for the Board's agenda.

Mr. Grissom, the Administrator, and Ms. Chapin, the General Counsel, have the longest tenure with the System. Aside from some changes in the Assistant Administrator position, there has had been little turnover among SDCERS' Executive Staff. Paul Barnett served as the Assistant Administrator from September 2001 until he passed away in the Summer of 2005.

Mr. Grissom had been the Administrator since 1987. He retired at the end of 2005. The Board is currently searching for his replacement. As Administrator, Mr. Grissom's duties included, among other things, managing the routine affairs of the office, interacting on behalf of the Board with the actuary, the investment manager and any

²⁹ According to the June 30, 2003 CAFR, the most recent year available.

other outside consultants hired by the Board to assist in carrying out its duties, and overseeing the Staff. To help carry out his administrative duties he was assisted by the Assistant Administrator, formerly Mr. Barnett, and currently Bob Wilson. Prior to joining SDCERS' Staff, Mr. Barnett served as the local bank appointee for the Board and Mr. Wilson worked in the City Auditor's office.

Ms. Chapin's role as General Counsel is to provide legal advice and assistance to the Board and Staff, including interaction with the SDCERS' outside fiduciary counsel. From 1990 to July 1997, Ms. Chapin worked with the Board while employed by the City Attorney's office as a Deputy City Attorney.

Prior to 1997, Deputy City Attorneys from the City Attorney's office provided legal services to the SDCERS' Board. In December 1996, the Board approved the creation of the positions of General Counsel and Assistant General Counsel to serve as legal counsel to the Board. The General Counsel was appointed by the Board and reported directly to the Board and the Administrator. The City Attorney and the Board agreed that these Deputy City Attorneys would become SDCERS' Staff effective July 1, 1997. Ms. Chapin has two associates to assist her—Roxanne Story Parks (Assistant General Counsel) and Sheila Leone Jacobs (Associate General Counsel). As a result of the indictments on January 6, 2006, Ms. Chapin has been placed on paid administrative leave³⁰ and Ms. Story Parks is the interim General Counsel.

The other members of SDCERS' Executive Staff during the time period under investigation are Douglas McCalla (Chief Investment Officer), Patrick Lane (Chief Financial Officer), David Arce (Operations Division Manager) and Vincent Hayes (Operations Division Manager).

- Mr. McCalla has been on SDCERS' Staff since September 1991 after serving on the Board beginning in January 1988. Mr. McCalla's function as Chief Investment Officer is to conduct the day-to-day investment and governance functions in accordance with the Board's investment objectives and policies, including providing investment recommendations, interact with external investment service providers and assist with the preparation of the financial statements of the SDCERS' Trust Fund.
- Mr. Lane joined SDCERS' Staff in 1991 as an Operations Manager. In his current role as Chief Financial Officer³¹, he oversees the financial and

³⁰ Navigant Consulting understands that Ms. Chapin will be on unpaid administrative leave once her annual leave account is exhausted.

³¹ Although Mr. Lane's title is "Chief Financial Officer", his duties differ from the typical responsibilities of a Chief Financial Officer. For example, he does not oversee SDCERS' financial reporting function or the preparation of SDCERS' financial statements.

technical management function, which includes conducting internal compliance reviews, providing information technology services and developing and monitoring budget activities and special studies as requested by the Administrator.

- Mr. Arce was appointed the Operations Division Manager in February 2002, replacing Vincent Hayes. He has several retirement counselors who report to him. As the Operations Division Manager, Mr. Arce oversees the day-to-day delivery of services and benefits to SDCERS' members, including the calculation of benefit estimates and payments.
- Mr. Hayes was the Operations Division Manager beginning in 1999 until he was replaced by Mr. Arce in February 2002. Mr. Hayes then became the Training and Marketing Division Manager until he retired in June 2005. As the Training and Marketing Division Manager, he was responsible for training staff and creating procedures on benefits administration and creating and developing materials used to communicate to SDCERS' participants and the public.

1. SDCERS' Staff Performance Evaluations and Compensation Adjustments

According to the SDCERS' Trustee handbook, the Board is responsible for conducting annual performance reviews of the Administrator. However, in reviewing Mr. Grissom's personnel file, he received sporadic evaluations, if any at all.

The Administrator's performance reviews are discussed in closed sessions of Board meetings. On July 17, 1998 the Board approved a 3% increase to the Administrator's base wage³², and an increase to purchase one year of additional service credit effective July 1, 1998 with one additional year of service credit following each additional year of his employment, subject to a maximum of five years as part of his compensation package.

In a closed session Board meeting on July 19, 2002, the Board approved the performance evaluation and a new compensation package for Mr. Grissom. Mr. Grissom would receive a 3% salary increase effective July 1, 2002. In addition, the supplement to Mr. Grissom's salary for purchase of service also increased by 3%. For fiscal year 2003, Mr. Grissom was eligible for an incentive-based salary increase up to 15% based upon (i) receiving an overall performance rating equal to or greater than 3.0 (fully competent), (ii) his overall job performance and (iii) achieving the milestones by the dates referenced in the "Administrator's Compensation Proposal."

³² Mr. Grissom's total earnings ranged from \$100,630 to \$197,207 between 1995 and 2005.

Mr. Grissom's total earnings, (i.e., earnings including any reimbursements, pre-tax deductions made to contribution plans and purchase of service credits) increased by approximately 8% per calendar year from 1995 through 2004. The biggest increases were during calendar years 2000 (20%), 2002 (12%) and 2004 (13%). The total cost of the purchase of service credit paid for by SDCERS for Mr. Grissom was \$79,550 during the years 2002 through 2004. Mr. Grissom retired effective December 31, 2005. By the time Mr. Grissom's accrued leave expires (approximately 2-3 months after his retirement date), SDCERS will calculate and begin paying Mr. Grissom's retirement benefit based on his highest one year salary. Navigant Consulting understands that 2005 is Mr. Grissom's highest one year salary. As a result, the salary increase Mr. Grissom received to purchase service credits will not be included in his retirement benefit calculation.

As the Administrator, Mr. Grissom hired and oversaw the submission of annual performance reviews of all SDCERS' Staff. According to Mr. Grissom, the Board was not involved with determining or approving the Executive Staff salaries other than his own. The total earnings of certain SDCERS' Staff, specifically Ms. Chapin, Mr. Lane and Mr. McCalla increased by approximately 8% per calendar year from 1995 through 2004. As non-classified City employees, their salary range is \$18,000 - \$207,000.

E. SDCERS' Outside Legal Counsel

1. Fiduciary Counsel

SDCERS engaged fiduciary counsel to provide legal advice to the Board. SDCERS followed a Request for Proposal ("RFP") process to identify prospective law firms. Historically, SDCERS' Staff recommended attorneys to the Business & Procedures Committee who selected the attorney to present to the Board for approval. During the period under investigation, the SDCERS' Board obtained legal opinion letters from at least the following law firms:

- Hufstedler, Kaus & Ettinger (Joseph Wyatt & Michael Toumanoff)
- Morrison & Foerster LLP (Joseph Wyatt & Michael Toumanoff, previously with Hufstedler, Kaus & Ettinger)
- Frandzel & Share (John Graham) and Hamilton & Faatz (Dwight Hamilton)
- Robert Klausner, Esq.
- Hanson, Bridgett, Marcus, Vlahos & Rudy LLP (Robert Blum and Constance Hiatt)

Navigant Consulting was unable to determine the reason for the changes in fiduciary counsel. Mr. Hamilton and Mr. Graham replaced Mr. Wyatt and Mr. Toumanoff around the time that the City presented the 1996 City Manager's proposal to the Board for

consideration. Mr. Blum and Ms. Hiatt's firm advised the Board in connection with the 2002 City Manager's proposal.

2. Litigation Counsel

With Board approval, SDCERS engaged counsel to represent SDCERS in connection with litigation filed against the Retirement System. Seltzer Caplan represented SDCERS in connection with the Gleason litigation (See Section VII.G).

SDCERS has hired other counsel which may not be discussed in this report.

3. Tax Counsel

Based on the results of Mercer's operational reviews in 2004, SDCERS engaged Ice Miller LLP to undertake an assessment of the System's status as a qualified plan under IRS regulations. SDCERS has applied to the IRS for a tax determination letter and has submitted a request under the IRS Voluntary Compliance Program ("VCP") regarding payments received from unions for union official's participation in SDCERS. As part of this process, SDCERS is no longer accepting contributions from the unions on behalf of union presidents. Navigant Consulting understands that Ice Miller's work is ongoing.

F. Relationship with the City of San Diego

SDCERS operates autonomously from the City. However, in some instances, it functions as if it were a City department. The City provides SDCERS with many support functions, including payroll processing, accounts payable and purchasing. The City's internal audit function periodically performs internal audits related to SDCERS' operations. SDCERS does not have its own personnel policy manual; it follows the City's Personnel Regulations in the absence of a specific SDCERS' policy. However, SDCERS is not listed as one of the City departments on the City's website. SDCERS is a separate legal entity from the City.

SDCERS employees' payroll is processed by the City from the SDCERS Trust fund. Other than Mr. Grissom and Mr. Barnett, many of the SDCERS employees are former City employees (e.g., Doug McCalla, Patrick Lane, Lori Chapin, Sheila Jacobs, Roxanne Story Parks, and Bob Wilson). Additionally, the SDCERS' employees are eligible to be, and generally are, SDCERS' members.

VII. Analysis of the Changes in the SDCERS' Funding Status

A. SDCERS Converted from the Entry Age Normal Actuarial Cost Method to Projected Unit Credit Funding Method

In 1991, SDCERS changed its actuarial method from Entry Age Normal ("EAN") to Projected Unit Credit ("PUC") concurrent with additional benefits granted to City employees. This is the earliest instance Navigant Consulting has identified where the SDCERS' Board agreed to lower the City's contribution levels at the same time that the City increased benefits for SDCERS' members, resulting in the SDCERS' Board positioned in the middle of labor negotiations. In a memo from Mr. Grissom to Bruce Herring, Deputy City Manager, dated May 14, 1991, Mr. Grissom wrote, "This is to confirm my understanding of the retirement items which were agreed upon in this year's meet and confer process. All of these benefit changes are subject to Retirement Board approval of the conversion from the entry age normal to the projected unit credit method of actuarial valuation."

The benefit enhancements described in Mr. Grissom's memorandum included an increase in the retirement benefit formula for Police and Fire members and retiree health insurance benefits to be paid from a newly created trust fund. The memorandum also discussed the reduction in the City's contribution rate resulting from the change to PUC identified as "Savings from PUC." The City contribution rates were shown to decline from 10.81% to 8.04% for Safety members and from 5.51% to 2.74% for General members.

The reduction in City contribution rates was directly offset by the added costs of the new benefits. However, ongoing costs of retiree health insurance costs not intended to be covered by the City's contribution to SDCERS. An amount equal to the reduction in City contributions for the fiscal year ended June 30, 1992 was to be placed into the retiree health insurance trust fund for that year only. Thereafter, the retiree "health insurance premium costs will continue to be paid from surplus undistributed earnings. In any year in which surplus undistributed earnings are insufficient to pay health insurance premium costs, the deficit will be paid from the health insurance trust fund." The impact of these changes was that the City would be contributing at a lower contribution rate even though additional retirement and retiree health benefits were granted.

In subsequent years, SDCERS experienced increases in its PUC rates because the average attained age of the active members increased. Nonetheless, the System's actuarial consultants, Gabriel Roeder Smith ("GRS"), advised that shifting back to EAN may result in a significant near-term contribution increase in its June 30, 1996 actuarial valuation.

The City made payments for retiree health costs directly into a separate trust and received a credit from SDCERS by reducing the pension contribution for an equal amount. At the time, the cost of retiree health premiums was approximately \$5 million per year. This practice continued through fiscal year 1995 when fiduciary counsel opined that contributions for pension benefits should not be reduced for post-retirement medical benefits.

The PUC actuarial method is an accepted method for determining contribution rates and funded status of a retirement plan. In 1991 and continuing today, PUC is less commonly used than EAN. Although this change pre-dated the appointment of GRS as the SDCERS' actuary, Rick Roeder told Navigant Consulting during his interview that the main reason retirement plans change from EAN to PUC would be to achieve a reduction in contributions. When Mercer performed its audit of actuarial work in 2004, they commented that "The Projected Unit Credit method tends to have a normal cost which increases as an employee ages. This causes more costs to be borne by those active taxpayers later in the member's career." Mercer further observed that "The PUC is an accepted cost Method under GASB. Based on a survey by the Public Coordinating Council, only 11 percent of public sector funds use the PUC method. The primary reason for this is that the PUC method tends to push more of the costs into the later part of a member's service. For this reason, the PUC method generally has a lower accrued liability than the most prevalent method which is Entry Age Normal."

The SDCERS' Board recognized that PUC was a less desirable method for establishing contributions and Board members expressed the desire to eventually return to the EAN method. GRS was asked to calculate EAN contribution rates in its valuations in the June 30, 1999 valuation. The contribution rates established under MP1 were to be increased by 0.50% per year until they reached the EAN rate.

B. The SDCERS' Board Changed the Amortization Period

At the same time as the change to the PUC method (1991), the SDCERS' Board changed the amortization period used in its actuarial valuations to a declining 30 year period, which is the maximum time period permitted under actuarial standards.³³ During his interview, Mr. Grissom told Navigant Consulting that this change occurred because the previous amortization period was close to ending and needed to be reset. The impact of

³³ Unfunded liabilities are typically funded over a specific time period. Thirty years is traditionally the longest period used for pension funds. The thirty years is approximately equal to the average time between the date of hire and the date of retirement. In 1991, there were no specific limits on the period that could be used for public sector plans and a few plans used a funding period of as long as forty years. GASB Statement No. 25 permitted amortization periods of up to forty years through 2004. After 2004, GASB No. 25 limited amortization periods to no more than thirty years.

this change would be lower contribution levels by spreading the recognition of the unfunded accrued liability over a longer period of time.

C. The City Made One-Time Contribution Relief Proposals to the SDCERS' Board

In July 1994, SDCERS established an Earnings Stabilization Reserve from the previous fiscal year's earnings. At the January 20, 1995 SDCERS' Board meeting, Board member and City Auditor Ed Ryan requested that \$8 million be transferred from the reserve to cover part of the City's contribution for that year. The Board voted to refer this matter to outside fiduciary counsel. The Board members held additional discussions on this matter at the February 24, 1995 Board meeting. The Board members attended a special Board meeting on March 24, 1995 to discuss the Corridor Concept³⁴ and the Earnings Stabilization Reserve. At the March 24th meeting, Mr. Ryan requested that \$9.3 million be transferred from the reserve effective June 30, 1995 to cover a shortfall in the City's contribution subject to sufficient earnings at that time to do so.

There was extensive discussion on this matter at the March 24, 1995 Board meeting. Mr. Grissom reported that he had received written communication from Morrison & Foerster LLP, outside fiduciary counsel, stating that it was within the Board's discretion to establish such a reserve, but that the written opinion did not address the appropriateness of transferring the reserve. Bruce Herring stated that the City's budget did not include a provision that these funds would be contributed to SDCERS for the current year and stated, "The impact of not transferring these funds [reserves] would in effect result in an approximate \$9 million reduction to the general fund." Mr. Ryan noted that the longer the City waits in any year to take a budget cut, the harder it is to spread the impact over time. The Board voted 7 to 6 in favor of the motion to approve the City Auditor's request to transfer from the Earnings Stabilization Reserve to the Employer Reserve in the fiscal year ending June 30, 1995, if there are sufficient surplus undistributed earnings, "contingent upon receiving a written opinion from outside fiduciary counsel that this action is appropriate and within the Board's fiduciary responsibility." During this meeting, the Board discussed the appropriateness of the City using such a reserve for the one time contribution relief it was seeking.

In its March 23, 1995 legal opinion letter, Morrison & Foerster LLP advised the Board that the earnings transfer from the Earnings Stabilization Reserve was appropriate. However, at the May 1995 Board meeting, Morrison & Foerster LLP advised the Board that the transfer of funds was not appropriate since the System's earnings were not what had been expected. As a result, no such transfer occurred. During the meeting, some Board members recommended obtaining a second legal opinion while other Board

³⁴ An alternative method of funding discussed at the March 24, 1995 Board meeting that would keep the funded ratio within a range (i.e., "corridor").

members said, "The fact that the Board does not like this answer is not justification to seek a second opinion." The motion to obtain a second legal opinion failed due to lack of a second.

Sometime in 1995 or 1996, the City inquired about the SDCERS' Board allowing a "contribution holiday." This request possibly occurred in connection with additional costs that the City faced for the Republican National Convention hosted in August 1996. It does not appear that the City submitted this request to the Board. As a result, the Board took no action to reduce the City's contribution for this idea.

D. The City Requested Contribution Relief in the City Manager's Proposal Presented to the SDCERS' Board in 1996

1. MP1 Factual Conclusions

a. MP1 Resulted in Underfunding to the System

The SDCERS' Board approved the City Manager's request to fund the System at less than the actuarially determined contribution rate. This action, coupled with the increase in costs from retirement benefit enhancements, created a liability to the System. It does not appear that the Board performed an appropriate analysis to understand the potential impact that MP1 would have on the future funded status of the System.

b. Concerns Raised about Conflicts of Interest

The Board was aware of concerns about potential conflicts of interest. For instance, Board member John Casey raised such a concern. Fiduciary Counsel addressed Mr. Casey's concerns after the Board approved MP1 by saying that Board members who act in the best interests of both the members of the System and the City by minimizing employer contributions do not have a conflict of interest.

c. Concerns Raised about the City Deferring Contributions to the Future and the City's Ability to Pay

Board members John Casey and Ann Parode voiced concerns at Board meetings prior to and at the time of the approval of MP1 over the increased liability of the City and the resulting impact to System funding levels. There is a lack of evidence that the Board monitored the City's credit worthiness over the term of MP1.

d. The City Placed the SDCERS' Board in the Center of the City's Benefit Policy

The City placed the SDCERS' Board in the center of benefit policy issues by making the approval of the contribution stabilization portion of MP1 necessary for the benefit enhancements. The City had responsibility for benefit policy, not the SDCERS' Board. By approving MP1, the SDCERS' Board did not object to the linkage of increased benefits and the City's decreased contributions.

e. The City Did Not Fund Retiree Health Costs

The City transferred the obligation to pay retiree health costs to SDCERS. However, the City provided no additional contributions to SDCERS to pay for these benefits.

f. The SDCERS' Board Was Time Pressured to Consider MP1

The SDCERS' Board faced time pressures during its consideration of MP1 due to the City's funding and budgetary cycle. Increased benefits were negotiated between the City and labor unions in March and April of 1996 and intended to take effect starting the new fiscal year, July 1, 1996. Additionally, the City was attempting to finalize its budget for the next fiscal year. At least two Board members, Paul Barnett and Jack Katz, raised concerns about the hastiness of the proposal.

g. Reliance on Strong Investment Returns

The Board members and City officials may have assumed that the strong investment returns would continue to offset the City's contribution shortfall and pay future benefits for retiree health costs, the 13th check,³⁵ and SDCERS' administrative expenses. During the late 1990s, strong investment returns were sufficient to offset (i) the contribution shortfall created by MP1 and (ii) the items funded out of Surplus Undistributed Earnings. The shortcomings of MP1 became apparent when investment performance declined resulting in the need for MP2.

h. MP1 Contained No Provisions to Address Actuarial Assumptions or Future Benefit Changes

The SDCERS' actuary concluded that certain key demographic information of the System's participants was changing. These changes should have resulted in the City paying higher contributions. However, because the contribution rate schedule under

³⁵ Retirees receive a supplemental retirement benefit, known as the "13th Check", which is paid out of the System's Surplus Undistributed Earnings. The benefit resulted from litigation which occurred in the 1980's.

MP1 was fixed, the changes did not impact the amount of the City's contribution rates. The benefit enhancements that resulted from the Corbett settlement also added costs to the System but were not factored into the City's contributions. Both of these factors adversely impacted SDCERS' funded ratio.

i. Actuarial Valuations Prepared for SDCERS Contained
Misleading Statements about SDCERS' Funding

The annual actuarial valuations describe SDCERS' funding objectives based on actuarial methods and assumptions. However, due to MP1, the actuarial methods or assumptions presented in the actuarial valuation were not used to determine the actual funding levels of the System. Rather, SDCERS allowed the City to contribute at less than the actuarially determined rate and defer the liability from increased benefit costs.

j. SDCERS' Comprehensive Annual Financial Report
Contained Misleading and/or Missing Disclosures
Regarding the Funding of the System

There are specific accounting disclosure requirements that would have highlighted the City's underfunding. However, SDCERS and its independent public accountants did not include the required disclosures that the City was contributing less than actuarially determined rates. It was not until fiscal year 2001 that the CAFR included a table disclosing the differences between the actual contribution amount and the Actuarial Required Contribution ("ARC") amount.

2. Overview of 1996 City Manager's Proposal

On May 2, 1996, the City Manager, Jack McGrory, introduced a proposal at a SDCERS' Board meeting that increased retirement benefits for General and Safety members and also allowed the City to fund the System at less than the actuarially determined amount. This proposal was later adopted by SDCERS' Board on June 21, 1996. The ongoing budgetary constraints of the City prior to the proposal caused it to seek a reduction in its retirement contribution from the Board. This continued a practice that had begun as early as 1991. Given the City's financial constraints in 1996, it entered into agreements with the labor unions to increase retirement benefits rather than salary increases which would have required a greater outlay of funds in the near term. The benefit increases coupled with contribution reductions began to put pressure on the funded status of SDCERS, which had ranged between 92.3% and 101.9% since 1989. The exchange of funding relief for increased retirement benefits is memorialized in the City Manager's Proposal (now known as "MP1").

3. Involvement of City Personnel, SDCERS' Staff and Board Members

MP1 was presented to the Board by the then City Manager, Jack McGrory, at a Special Board meeting of the SDCERS' Board on May 2, 1996. In May and June of 1996, City representatives met with union representatives during the "meet and confer" process to discuss increases to retirement benefits. As stated in the Special Board meeting minutes:

"In exchange for benefits improvements contained in the proposed package, [Mr. McGrory] stated that the City needs help with the Earnings Stabilization Reserve."

The minutes further summarized:

"Mr. McGrory stated that [the City] has already been talking with the employee organizations and would like to memorialize this by May 30, 1996."

The retirement proposal from a May 28, 1996 closed meet and confer session shows increases in retirement benefit formulas for General and Safety members followed by contract extensions with Local 145, MEA, Local 127, and POA. Subsequently, these contract extensions were modified suggesting that the City continued to negotiate with the unions after the introduction of MP1. The agreements between the City and unions were formalized by June 5, 1996 through Memorandums of Understanding ("MOUs") and the City was then granted funding relief on June 21, 1996 with the approval of the City Manager's proposal by the SDCERS' Board.

The idea of the City's Manager's Proposal dates back to at least as early as February 1996 when the City Manager discussed it with the SDCERS' Board President and Administrator. In a draft memorandum from Mr. McGrory dated February 29, 1996, Mr. McGrory outlined proposed funding and retirement changes. The memo suggested that this proposal was discussed several months prior to the introduction of the City Manager's proposal at the SDCERS' Board meeting in May 1996. The memo stated: "Here's the outline of the package we discussed with Keith [Enerson] and Larry [Grissom]." Mr. McGrory proposed stabilizing the City's contribution rate at the lower bifurcated rate in fiscal year 1996 through the next 3-5 years as well as funding retiree health insurance from reserves, which was later identified as the Health Insurance Reserve.

On March 1, 1996, SDCERS' Administrator, Larry Grissom,³⁶ issued a memorandum to the SDCERS' Retirement Board President, Keith Enerson, proposing an implementation plan for the retirement package that was discussed with the City Manager on February 26, 1996. In this proposal, Mr. Grissom acknowledged that the unfunded liability of the System will increase and that there may be a perception that the System is "giving" the City a lot of money. He closes by stating: "This is a good plan. It gives the City nearly \$45 million of rate relief over the next 5 years."³⁷ Subsequently, a concept overview of the City Manager's proposal was drafted and presented to the Board at a special meeting on May 2, 1996 by Mr. McGrory. He sought input from Board members to later return with a formal proposal for the Board's review and action.

Besides City Manager Jack McGrory, other City personnel collaborated with Board members, the Administrator and other SDCERS' Staff to jointly develop MP1.

- As early as February 1996, Administrator Larry Grissom, SDCERS' Board President Keith Enerson, and City Manager Jack McGrory discussed the concept of the City Manager's proposal.
- Larry Grissom described his role with MP1 as that of "facilitator." Mr. Grissom provided the Board direction on which items of the City Manager's proposal the Board could vote in a memorandum dated June 12, 1996.
- Deputy City Manager and Board member Bruce Herring participated in the development of the City Manager's proposal. He requested legal advice from Jeffrey S. Leavitt of Jones, Day, Reavis & Pogue concerning the fiduciary implications of the proposal. In his letter, Mr. Leavitt stated: "As I understand it, the proposed changes described in the Outline (the "Proposal") are the result of discussions between the Plan Administrator of the San Diego City Employees' Retirement System and your Office, and are being discussed with labor organizations representing the City's employees as part of the current meet and confer process."

³⁶ Navigant Consulting identified no legal advice provided by Lori Chapin (known as "Lori Etherington" at the time), the City Attorney assigned to SDCERS during MP1. John Witt, the City Attorney at that time of MP1, notified the SDCERS' Board in a letter dated April 23, 1996 that it should hire its own fiduciary counsel to provide advice to the Board regarding MP1. Mr. Witt stated that he was uncomfortable providing advice to the Board since he would personally benefit from the benefit changes.

³⁷ The actual amount of rate relief turned out to be much greater.

- Ed Ryan's role as the City Auditor is unclear in the development of the proposal although he had previously requested³⁸ the Board to provide the City with funding relief a year earlier at a special Board meeting on March 24, 1995. He was also a Board member at the time.
- Labor Relations Manager Cathy Lexin³⁹ played a key role in the development of the proposal. She worked with Mr. Grissom on reviewing the proposal and negotiated with the unions on retirement benefits. In Mr. Grissom's memo to Ms. Lexin regarding revisions to the City Manager's proposal, he provides guidance with statements such as "You should make sure that your presentation makes this point crystal clear", "You should incorporate this language in a plan revision", and "Best thing is to delete it from the proposal and deal with those issues separately."
- During Navigant Consulting's investigation, Ann Parode provided the following answer to written questions: "Ron Saathoff appeared to me to be the principle advocate of the proposal, in addition to the City Manager and his assistants who also spoke in support of it."

4. Discussions at SDCERS' Retirement Board Meetings

Between May and June 1996, MP1 became a central topic of discussion at SDCERS' Board meetings. When the proposal was first formally introduced to the Board on May 2, 1996, Board member John Casey stated that legal fees had previously been incurred evaluating a similar proposal the year before and the Board was advised by counsel not to move forward with the plan. At this meeting, SDCERS' Board President, Keith Enerson, stated that the proposal would need to be reviewed by both the actuary and fiduciary counsel. At this meeting, Mr. Enerson also recommended to change fiduciary counsel from Joseph Wyatt of Morrison & Foerster LLP to Dwight Hamilton.⁴⁰

A revised City Manager's proposal was issued June 7, 1996 and discussed at a special Board workshop on June 11, 1996. At this meeting, Mr. Enerson concurred with Mr. McGrory that the proposal would solve the City's short and long term problems and

³⁸ Based on Navigant Consulting's interviews and review of the Board minutes, some of the Board members may have felt that Mr. Ryan pressured the Board to provide the City with funding relief.

³⁹ Ms. Lexin was not serving as a Board member during this time.

⁴⁰ Navigant Consulting has not been able to ascertain why there was a change in fiduciary counsel. There was a comment in the Board minutes that it was due to lack of responsiveness on the part of Mr. Wyatt, but SDCERS' personnel could not recall that being an issue. Navigant Consulting noted that Mr. Wyatt was counsel in the *Claypool* case which was later deemed an important case for the determination of fiduciary duty related to MP1 and MP2.

lead to more positive relationships with the City. Board member Ron Saathoff favored the DROP program⁴¹ as he believed it would benefit individuals who had reached the 90% cap. Conversely, Mr. Casey raised a number of concerns. He questioned how the Board was planning to fund retiree health and DROP. He also expressed concern about the long-term impact to the System of creating contingency and stabilization reserves. He stated that it was inappropriate for the future generations to pay for retirement benefits of today's generation. Additionally, Board member Ann Parode questioned how far unfunded the System could become before the Board's fiduciary responsibilities were challenged.

At the next meeting on June 21, 1996 during which MP1 was approved, Ms. Parode stated that the Board as trustees should be concerned about the increased liability of the City. She also stated that the sunset provision does not really exist because the benefit package would still remain in effect if the funding ratio were to drop by more than 10%. Mr. Saathoff stated his view that retiree health insurance would be paid from surplus earnings and the City would be responsible in the event that there is no surplus. However, Mr. McGrory urged the Board to protect the City from having to pay retiree health insurance.⁴² He also stated that the City's contribution rate would not be locked; it could change depending on the demographics of the System.⁴³ Mr. McGrory closed his comments by saying that the plan is an attempt to responsibly manage the City's contribution rates and that he believed it was a wise decision.

At the end of the discussion, Bruce Herring made the motion to adopt MP1 and Robert Scannell seconded the motion, which was passed in an 8-3 vote. During an interview with Conny Jamison, Ms. Jamison stated that she had opposed the original proposal presented by the City Manager since it did not contain a floor (i.e., require additional contributions if the funded ratio dropped below a certain level). Ms. Jamison ultimately voted for the proposal since neither the actuary nor fiduciary counsel opposed it, the City Manager added a floor and she felt pressured by the City to approve it. Board members Jack Katz, Ann Parode, and Paul Barnett voted against the proposal. John Casey was not present for the vote but had previously and subsequently raised concerns.

Ultimately, approximately two months passed from the time the proposal was first introduced at the May 2, 1996 Board meeting to the time the Board approved the

⁴¹ The Deferred Retirement Option Plan ("DROP") was one of the 1996 benefit enhancements. It is described in Section VII.E.b.

⁴² The City was not planning to provide any funding for the costs of retiree health. The contribution rates were established under MP1 from a base that consisted only of retirement and disability costs. The unrealistic hope was that surplus earnings would always be available to cover this growing cost.

⁴³ The contribution rates set in MP1 remained in effect until MP2.

proposal on June 21, 1996. During that two month period, drafts were created dated June 4, 1996 and June 7, 1996. The final proposal was a combination of the June 7, 1996 draft and additional modifications introduced in a memo dated June 21, 1996 from Mr. McGrory.

5. Summary of MP1

The City Manager's proposal presented four issues, three of which the Board had authority to approve or deny.⁴⁴ The Board did not have the authority to vote on benefit changes. The Board voted on the funding of retiree health insurance, the employer contribution rates, and the use of surplus undistributed earnings and reserves. All issues presented in the proposal are discussed in more detail below.

a. Retiree Health Insurance

MP1 proposed that retiree health insurance become an obligation of SDCERS effective July 1, 1997, relieving the City of its responsibility to provide retiree health insurance. The proposal was contingent on SDCERS' fiduciary counsel deeming this action legal and appropriate before January 1, 1997. It was the City's intention that retiree health costs would not be paid on an annual basis from Surplus Undistributed Earnings.

As part of the proposal, it was suggested that the City's health insurance trust, which was valued at approximately \$12.5 million, be used to pay for Fiscal Year 1997 retiree health insurance. At the same time, SDCERS would establish a health insurance reserve. A dollar amount commensurate to the projected costs for retiree health insurance would then be transferred from Surplus Undistributed Earnings and credited to this reserve account on an annual basis. Actual premium costs and administrative charges were to be charged to the health insurance reserve on a pay-as-you-go basis and would not be actuarially funded.

The City Manager's proposal also provided that premium reimbursements for POA and Local 145 Retiree Health Plans would increase from \$4,500 per year to \$4,995 per year. However, this increase would only apply during fiscal year 1997.

Unlike other retiree obligations, retiree health insurance obligations for pre-1980 retirees would remain with the City, and at the same rate as fiscal year 1996, until the end of fiscal year 1997. Furthermore, pre-1980 retiree health insurance was to become an ongoing benefit. However, the City Manager's proposal indicated that this was contingent upon retiree health insurance obligations being shifted from the City to SDCERS.

⁴⁴ Before the Board could vote on retiree health insurance, the City Council had to change the San Diego Municipal Code to authorize SDCERS to provide health insurance to retirees.

Finally, during fiscal year 1997, the City Manager, SDCERS' Board and Labor Organizations were to create a Task Force whose purpose would be to develop the necessary documentation to design a tax exempt health insurance benefit to be effective July 1, 1997. The Task Force was to work with actuaries, consultants and legal counsel to facilitate this process. The Task Force's recommended benefit level would be subject to SDCERS and the City Council's approval. In addition, the Task Force would have to issue a Request for Proposal to facilitate the selection of a common provider. POA and Local 145 would have to assume full responsibility for any claims incurred under existing health insurance policies. The Task Force was expected to complete its work and present its recommendations by November 1, 1996.

b. SDCERS' Benefit Changes

SDCERS' benefit changes did not require any action by the SDCERS' Board but were part of the overall City Manager's proposal.

i. Eliminate the Existing Requirement to Offset Disability Income

Changes to SDCERS' benefits included the elimination of a requirement designed to offset disability income.

ii. Purchase Service Credit

Certain service credit provisions were to continue undisturbed, including refunds, probationary periods, the "1981 Plan" waiting period and the Military & Veteran code. All other service credit provisions were to be incorporated into a new general provision. The 1996 City Manager's proposal also included a five-year purchase of service credit feature, which would be available half-time and three-quarter-time employees. Under the new benefit, employees would pay into the retirement system an amount, including interest, equivalent to the employee and employer full cost of such service.⁴⁵

iii. Increase Calculations for 13th Check

Additional changes to SDCERS' benefits were reflected in changes to the supplemental "13th Check" calculation for certain employees, specifically pre-10/06/80 retirees and pre-

⁴⁵ SDCERS established a uniform rate for purchase of service credits which later turned out to be below the true cost. See Section VII.E.3.b for further discussion.

12/31/71 retirees.⁴⁶ Pre-10/06/80 retirees received an increase in their check calculation from \$30 to \$60 per creditable year of service. Pre-12/31/71 retirees, however, received an increased their check calculation from \$30 to \$75 per creditable year of service. In addition, it was the City Manager's intent to conduct a study during the first quarter of fiscal year 1998 on Cost Of Living Adjustments ("COLA") alternatives, including, but not limited to, a 75% purchasing power formula.

iv. Increase Benefits for General Members

SDCERS' benefit changes also included increased benefits to General members for industrial disability retirements from 33.33% to 50%. In addition, the General member formula was altered as follows:

Age	Present Factor	Proposed Factor
55	1.48%	2.00%
56	1.56%	2.00%
57	1.63%	2.00%
58	1.72%	2.00%
59	1.81%	2.08%
60	1.92%	2.16%
61	1.99%	2.24%
62	2.09%	2.31%
63	2.20%	2.39%
64	2.31%	2.47%
65 +	2.43%	2.55%

v. Increase Benefits for Police & Fire Safety Members

SDCERS' benefit changes also included improvements to the Police and Fire Safety member formula:

⁴⁶ Pursuant to the San Diego Municipal Code, SDCERS distributes the supplemental "13th Check" benefit each year to eligible retirees if SDCERS has realized sufficient surplus undistributed earnings from the previous fiscal year.

Age	Fire Factor	Police Factor	Proposed Factor for Fire & Police
50	2.20%	2.50%	2.50%
51	2.32%	2.54%	2.60%
52	2.44%	2.58%	2.70%
53	2.57%	2.62%	2.80%
54	2.72%	2.66%	2.90%
55 +	2.77%	2.70%	2.9999%

SDCERS' benefit changes to the Police and Fire Safety member formula included a 90% cap on benefits. Employees eligible for a percentage above 90% on the date the new formula became effective would be allowed to remain under the old formula, which was to operate without a cap.

vi. Increase Benefits for Lifeguard Safety Members

SDCERS' benefit changes also included improvements to the Lifeguard Safety member formula:

Age	Present Factor	Proposed Factor
50	2.00%	2.20%
51	2.10%	2.32%
52	2.22%	2.44%
53	2.34%	2.57%
54	2.47%	2.72%
55 +	2.62%	2.77%

SDCERS' benefit changes to the Lifeguard Safety member formula also included a 90% cap on benefits. Employees eligible for a percentage above 90% on April 1, 1997, which is the effective date of the Deferred Retirement Option Plan ("DROP") implementation, would be fixed at their rate.

vii. Implement DROP

The City's implementation of Deferred Retirement Option Plan ("DROP"), effective April 1, 1997, contingent upon the condition that the plan be approved by the City Attorney's Office and that it would not increase costs greater than City and SDCERS' savings. Employees would be allowed to participate in DROP for up to five years.

Employees who elect to participate in DROP, however, would cease participation in SDCERS, and would participate instead in an SPSP-type plan⁴⁷ with a mandatory 3.05% employee contribution matched by a 3.05% employer contribution.

At the end of three years, the City planned to evaluate the cost impact of the DROP program. If it was determined that the cost impact is greater than savings, the City and unions would address DROP during the meet and confer process. If the City proposed to change DROP, however, the 90% cap on SDCERS would also be re-negotiated.

c. Employer Contribution Rates

It was stated in the proposal that employer contribution rates would be calculated using the Projected Unit Credit ("PUC") method. For fiscal years 1996 and 1997, the City would pay rates of 7.08% and 7.33%, respectively, which are less than the PUC rates calculated during the June 30, 1996 actuarial valuation. In comparing fiscal year 1996 rates, the PUC contribution rate at December 31, 1996 including the benefit enhancements of MP1, would have been 10.87%, reflecting a difference of 3.79% of payroll. Prior to the increased benefits, the PUC contribution rate would have been 8.71%. Thereafter, the City would increase the rate paid by 0.50% each year until the rate paid reaches the Entry Age Normal ("EAN") calculated rate. At such a time, SDCERS would convert from the PUC to the EAN method by fiscal year 2007 or 2008. The MP1 contribution rates are shown on the following table:

Period	PUC Rate	City Paid Rate	Difference %	Difference \$ ⁴⁸
FY96	8.60%	7.08%	1.52%	\$5.33m
FY97	10.87%	7.33%	3.79%	\$13.88m
FY98	12.18%	7.83%	4.35%	\$16.67m
FY99	12.18%	8.33%	3.85%	\$15.40m
FY2000	12.18%	8.83%	3.35%	\$14.00m
FY2001	12.18%	9.33%	2.85%	\$12.45m
FY2002	12.18%	9.83%	2.35%	\$10.72m
FY2003	12.18%	10.33%	1.85%	\$8.82m
FY2004	12.18%	10.83%	1.35%	\$6.73m
FY2005	12.18%	11.33%	.85%	\$4.43m
FY2006	12.18%	11.83%	.35%	\$1.91m
FY2007	12.18%	12.18%	0%	\$0
FY2008	13.00%	13.00%	0%	\$0
TOTAL				\$110.35m⁴⁹

⁴⁷ SPSP referred to the City's Supplemental Pension and Savings Plan.

⁴⁸ The dollar difference was calculated at a point in time. The amount changed based on the actuarial valuation of the PUC rate.

The City agreed to pay the budgeted rates for fiscal years 1996 and 1997. However, the City Manager's proposal also stated the following:

"In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation."

If the SDCERS' actuary were to make changes in methodology or actuarial assumptions which are approved by the Board prior to July 1, 2007, any alterations to the employer contribution rate would also cause alterations to the PUC rate through extended incremental increases. If these rate changes extended the time needed to complete the EAN method phase-in process past July 1, 2009, then the City-paid rate would be adjusted by the amount necessary to achieve full phase-in by that date.

d. Surplus Undistributed Earnings and Reserves

In the years prior to MP1, the City used "reserves" created from "excess earnings" to fund some of its retirement benefits. The San Diego Municipal Code specifically allows Surplus Undistributed Earnings to fund retirement benefits, including retiree health and benefits provided in the Corbett settlement. The City continued to rely on Surplus Undistributed Earnings after MP1. Mr. Grissom explained to the Board at the June 21, 1996 Board meeting that the Board was being asked to approve a method of funding those contribution rates at a point lower than what the actuarial rates are, and to achieve those rates incrementally over time. The difference between the actuarial contribution rates and actual contribution rates would be funded out of the surplus earnings at the time. At the same time the Board agreed to the reduce contributions from the City, SDCERS continued pay retiree health and 13th check for which the City was not contributing to SDCERS. See additional discussion in Section VII.D.5.a - c.

⁴⁹ The MP1 document noted that of the \$110.35 million paid from excess earnings, \$71.31 million relates to benefit improvements.

6. Legal Opinions, Actuary Analysis and Board Members'
Comments on MP1

The Board's review and action was dependent upon the assistance and opinions of the SDCERS' actuary and fiduciary counsel.⁵⁰ As such, between May 2 and June 21, 1996, the Administrator involved these experts to review MP1.

a. SDCERS' Actuary Analysis

On May 25, 1996, the SDCERS' actuary Rick Roeder provided an analysis of costs to the System associated with increased retirement formulas for General and Safety members. Using the retirement factors as outlined in MP1, Mr. Roeder estimated a total increase in accrued liabilities of \$76.3 million as a result of the benefit improvements. Mr. Roeder also provided an estimate of the increase to the actuarially calculated contribution rates resulting from the enhanced benefits. The impact was estimated to increase the combined rates by 3.07% of payroll. However, Mr. Roeder's letter did not compare the increases or what the new rates would be to the schedule included in the City Manager's proposal. Mr. Roeder later issued another letter to Mr. Grissom dated June 13, 1996 in which he estimated the total accrued liabilities to be \$76.7 million using the same retirement factor increases but different contribution increases.

Although there were discussions at the June 11, 1996 Board workshop about an opinion letter from the actuary, it does not appear that GRS issued an actuarial opinion letter. Rather, Mr. Roeder's comments are documented in Retirement Board meeting minutes.

Mr. Roeder's comments addressed Mr. McGrory's conclusions that increases to the unfunded liability could be covered by excess undistributed earnings. Mr. Roeder stated at a meeting of the Retirement Board on June 11, 1996 that the proposal was actuarially sound given the appropriate sunset provisions. He also stated at this meeting that the funded ratio as of June 30, 1995 was 93.5% and would drop 5% if the funding proposal was adopted absent any benefit improvements.⁵¹ Mr. Roeder did not

⁵⁰ SDCERS engaged Dwight Hamilton as fiduciary counsel in connection with MP1. At the May 2, 1996 Special Board Meeting, Mr. Enerson stated that the Board would not be using "Joe Wyatt's firm" (Morrison & Foerster LLP) to review MP1. Mr. Casey questioned why the Board wouldn't use Mr. Wyatt's firm since it was already familiar with and had been educated about the System. Mr. Casey also questioned why the Board was engaging additional counsel when the Board had evaluated a similar proposal in the prior year for which fiduciary counsel had advised it could not be done.

⁵¹ It is important to note that the investment returns during this time period were very strong generating investment income greater than the assumed rate of return. These returns more than offset payment of the 13th check. Nonetheless, the funded status of the system was declining during a bull market.

provide, nor did the Board request, projections of contribution rates or sensitivity analyses on the System's funding that reflected the impact of proposed benefits.

b. City Attorney and the City's Fiduciary Counsel Opinion

City Attorney John Witt recommended in a letter to the Retirement Board dated April 23, 1996 that the Board seek assistance from outside fiduciary counsel in reviewing the proposal because of the important fiduciary considerations. Due to the fiduciary implications of the proposed plan, Jeffrey Leavitt was engaged to offer legal advice to the City regarding it and the SDCERS' Board's fiduciary duties. In his letter to Bruce Herring on April 29, 1996, Mr. Leavitt stated:

"It is appropriate for the City, in designing and analyzing the Proposal, to take into account that, from the Board's point of view as a fiduciary, it should be reasonable for the Board to consider making these funding-related changes as part of an overall program of plan revisions which will be advantageous from the perspective of the members. The fact that the City would benefit under the Proposal does not automatically mean that the Board would breach its duty of loyalty to the members of SDCERS by approving the Proposal."

c. SDCERS' Fiduciary Counsel Opinion

Providing legal advice from SDCERS' perspective, Dwight Hamilton, fiduciary counsel to the SDCERS' Board, also opined on fiduciary duty and conflict of interest. Mr. Hamilton initially raised concerns which he considered "red flag" at the June 11, 1996 Board meeting. Specifically, his concerns dealt with credits/transfers of funds into reserves to pay for retiree health insurance, the lack of clarity on the City and Board's participation in the evaluation of the DROP program after three years, and the consequences of falling below the funding floor. These concerns were addressed in the next draft of the City Manager's proposal presented on June 21, 1996 to the Board. As a result, Mr. Hamilton opined that he was comfortable with the applicable items in the proposal⁵² and that the Board would not be violating its fiduciary duty if it was to approve the proposal due to the new revisions. He stated that the Board would not be violating its fiduciary duties if it was to approve the proposal with new revisions (resulting from his "red flag" concerns at the June 11, 1996 special meeting of the Board). He stated that the Board's actions under the proposal are agreeable under the rulings of the Claypool case.⁵³

⁵² Mr. Hamilton did not opine on two of the items since (i) the Board could not vote on retiree health care without a change to the San Diego Municipal Code and (ii) the Board can not vote on benefit changes.

⁵³ *Claypool v. Wilson*, 4 Cal.App.4th 646, 6 Cal.Rptr.2d 77 (1992). The case was a class action lawsuit regarding CALPERS' benefits.

In Mr. Hamilton's opinion letter dated June 21, 1996 to Mr. Grissom, he opined:

"Provided that the City-paid rate in the Employer Contribution Rate Stabilization Plan is not less than an amount substantially equal to that required of employees for normal retirement allowances as certified by the actuary, the Board will be acting within the discretion granted to the Board to administer the System and discharging its fiduciary duties set forth in Article XVI, Sec. 17 of the California Constitution."

Regarding crediting the employer contribution reserve from "surplus" undistributed earnings, he opined:

"It is now proposed that the Board of Administration, credit the employer contribution reserve in the amount of \$106,700,000 for the purpose of discharging the estimated liability for past service liability for increased benefits and employer contribution shortfall and credit the employer contribution reserve with the remaining balance of \$28,356,188 for the purpose of reducing the System's normal unfunded liability. We believe that it is appropriate and the Board will be discharging its fiduciary responsibility to credit the employer contribution reserve as proposed, provided that the requirements of Section 24.0907.1(a) of the San Diego Municipal Code have been met. Under the controlling San Diego Ordinances, any actuarially determined surplus earnings can be credited to the employer contribution reserve."

It is unclear why Mr. Hamilton gave such credence to the employer contribution reserve as this reserve is not an actual asset that could be used to fund pension liabilities.⁵⁴ Mr. Hamilton may have incorrectly believed⁵⁵ that these reserves were separate assets not deemed to be part of the general assets available for pension benefits. In the June 30, 1996 and June 30, 1997 valuations, GRS excluded these reserves from plan assets for valuation purposes, further illustrating that the Employer Contribution Rate Stabilization Reserve should not have been considered a factor in the Board's approval or fiduciary counsel's opinion regarding MP1.

Subsequently, Mr. Hamilton issued a letter dated September 19, 1996 (after the proposal was approved) to the Administrator in which he provided an analysis of the *Claypool v. Wilson* case as it relates to the actions of the Board under the City Manager's proposal. Here he stated:

⁵⁴ SDCERS used "reserves" to earmark Plan Net Assets for future anticipated liabilities. These reserves differ from accounting reserves.

⁵⁵ Mr. Hamilton passed away in July 2005. Navigant Consulting attempted to interview the local counsel with whom Mr. Hamilton issued joint opinion letters, but he declined to be interviewed.

“The case law permits a pension system to be flexible enough to permit adjustments in accord with changing conditions if at the same time the integrity of the system is maintained, and the change bears some relation to the functioning and integrity of the system.”

Mr. Hamilton further wrote:

“The stabilization of employer contribution rates is directly related to the functioning and integrity of the system.”

Mr. Hamilton also recommended to the Board that it undertake the necessary steps to evaluate the credit worthiness of the City through a review of audited financial statements, budget preparation that properly anticipates revenues and expenditures, and timely debt payment. Finally, Mr. Hamilton’s letter addressed the concern of conflict of interest for Board members personally affected by increased benefits.

Mr. Hamilton concluded:

“...it is our opinion that those Board members who voted in favor of the proposal solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system, did not have a conflict of interest sufficient to bar him or her from functioning as a trustee.”

d. SDCERS’ Board Members’ Concerns

Mr. Hamilton’s letter was developed in response to concerns by Board members John Casey and Ann Parode. On June 11, 1996, Ms. Parode wrote a letter to Mr. Grissom in which she questioned the financial impact of the benefit enhancements and the financial viability of the City. Mr. Hamilton advised the SDCERS’ Board in his September 19, 1996 letter that SDCERS was effectively granting credit to the City in the form of deferring contributions and that it would be prudent for the SDCERS’ Board to evaluate the City’s financial condition and ability to pay the higher contribution levels in the future. He suggested they may want to employ the services of an expert in municipal finance and government to assist. Such a review was discussed in subsequent Board meetings, but Navigant Consulting has seen no information that it was actually performed. Ms. Parode also questioned the purpose of reserve accounts and the funding mechanism for retiree health benefits. Through Navigant Consulting’s investigation, Ms. Parode stated that she was concerned with the City’s financial ability to meet its obligations to SDCERS on a long term basis due to the balloon payment for which there was no funding source.

After the SDCERS' Board approved MP1 on June 21, 1996, Mr. Casey issued a memorandum to fiduciary counsel, Mr. Hamilton, via Larry Grissom dated July 16, 1996, in which he stated that there was a real conflict in Board members approving a proposal that enhanced their financial benefit. He stated that the "Board action of June 21, 1996 is flawed." Arguing in favor of the proposal, Board President Keith Enerson assured the Board on June 11, 1996 at the Board workshop that all questions and concerns raised at the meeting would be addressed and outlined in a revised proposal prior to the Board taking action. He also confirmed that additional costs associated with DROP and retiree health benefits would not be paid by the System.

7. Impact on Funding and Unfunded Liability

GRS prepared the June 30, 1996 actuarial valuation, dated January 9, 1997, based upon the benefits currently in effect, and a comparative valuation reflecting the benefits that would be applied assuming MP1 was approved. The valuation indicated that the funded status at June 30, 1996, prior to including the new benefits granted at the time would have been 97.1%. The pro-forma valuation at June 30, 1996, reflecting the proposed MP1 benefit increases, determined that the funded status at June 30, 1996 after MP1 was 92.3%.

The MP1 benefits increased the project benefit obligation ("PBO") by \$129.3 million in total. Part of the increase (\$82.5 million) was attributable to retroactive benefits (\$71.3 million) was attributable future benefits. Prior to the adoption of MP1, the June 30, 1996 PBO was \$2,318.1 million. The pro-forma impact of MP1 increased the PBO to \$2,471.9 million, or an increase of approximately \$153.8 million. The accrued actuarial liability ("AAL") increased by the \$82.5 million past service cost from \$1,600.1 million to \$1,682.6 million. The increase in the AAL reduced the funded ratio from 97.1% to 92.3%.

The contribution schedule in MP1 also contemplated that SDCERS' surplus earnings would fund the shortfall between the Actuarial Required Contribution ("ARC") and the City's contribution rate stabilization plan. GRS estimated that the "cost" of the contribution shortfall would total \$30 million. This is the difference between the ARC and the City's contribution in the years before the City would again contribute the ARC. Mr. McGrory presented MP1 noting that there were "surplus earnings" of \$135 million in 1995 and 1996. "He stated that \$30 million of that [the excess earnings] would be for the City's contribution gap between what they would ramp-up in the budget and the actuarial rate."

Mr. Grissom stated, "The Board is being asked to approve a method of funding those contribution rates beginning at a point lower than what the actuarial rates are, and to achieve those rates incrementally over a period of time." He stated that the difference

between the actuarial and actual rates “would be funded out of today’s surplus earnings.”

The \$82.5 million retroactive benefit and \$30 million contribution shortfall, or a total of \$112.5 million was to be funded from a reserve established in 1994 and Surplus Undistributed Earnings in 1995 and 1996 s as follows:

Earnings Stabilization Reserve	\$	10,769,620
FY 1995 surplus earnings		38,813,314
FY 1996 surplus earnings		<u>85,472,254</u>
TOTAL	\$	<u>135,055,188</u>

It appears that the Board was told about the cost of MP1 for retroactive benefits and the City contribution shortfall. It is not apparent that the Board understood the total impact MP1 would have upon the funded status of the plan including the 13th check, COLA, retiree health benefits, and the future costs of increased benefits under MP1.

The first Comprehensive Annual Financial Report (“CAFR”) that SDCERS issued after the Board approved MP1 was dated February 20, 1998. The CAFR included fiscal years 1996 and 1997. The 1996/1997 CAFR highlighted the benefit improvements included with MP1, but did not include the corresponding agreement to reduce the City contributions below those recommended by the actuarial valuation. The notes to the SDCERS’ audited financial statements state that “SDCERS’ funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are designed to accumulate sufficient assets to pay benefits when due. The normal cost and actuarial accrued liability are determined using the projected unit credit actuarial funding method.” The actuarial section of the 1996/1997 CAFR, which is based on the June 30, 1996 actuarial valuation, states under the heading ‘City’s Contributions,’ “Determined by the projected unit credit funding method with a 30-year amortization of unfunded actuarial liability beginning on July 1, 1992.” These statements do not accurately and fully describe the basis for the City’s contributions for fiscal year 1997 because the statements did not disclose that the City’s contribution was less than the ARC amount calculated by the System’s actuary. This disclosure continued in subsequent CAFRs.

The GRS June 30, 1996 actuarial valuation report issued on January 9, 1997 contains a three page discussion at the beginning of the report about general funding policies in which it describes the concept of “level percent funding”. It describes the objective of having “this year’s taxpayers contribute the money to cover the IOUs being handed out this year. By following this principle, the employer contribution rate will remain approximately level from generation to generation – our children and our grandchildren will contribute the same percents of active payroll we contribute now.” This discussion

is inconsistent with the practice that was adopted as part of MP1 since the City's contribution was less than the ARC amount calculated by the System's actuary. A similar discussion appeared in subsequent annual actuarial valuations even as the gap between what was being funded and what was determined by the actuary continued to grow.

The June 30, 1997 actuarial valuation (the first valuation reflecting the increased benefits and MP1 contribution levels) prepared by GRS calculated SDCERS' funded ratio at 94.2%. GRS also noted that, "Since this funding method is not one of the six approved funding methods under the rules set by the Government Accounting Standards Board, our understanding is that the pension expense will need to be calculated under one of the six approved methods. An accrued pension expense may result. Later this year we will attempt to see if GASB will approve the City's funding method for expensing purposes." GRS concluded that "Overall, we believe the City's retirement system to be in sound condition in accordance with actuarial principals of level-cost financing."

The employer contribution rate is one of the key pieces of information provided by the actuarial valuation. GRS highlighted the employer contribution rate on the first page of each annual valuation. The rates are referred to as "ARC". Under GASB Statement No. 25, there are six approved funding methods, including PUC and EAN. However, the rates that the City contributed did not conform to any of these GASB prescribed methods. GRS' June 30, 1997 valuation disclosed that the City's contribution pursuant to MP1 was not one of the GASB approved funding methods.

8. Sunset Provision

As the funded status of the System changed, the interpretation of the sunset provision outlined in the City Manager's proposal became more important. The SDCERS' actuary, Rick Roeder, stated he would not have been comfortable with the proposal without it (see precise language above). However, different interpretations would later play a role in the approval of the second City Manager's proposal in 2002 (see Section VII.F.5).

E. Events Between City Manager's Proposal 1 and City Manager's Proposal 2

1. 1997-1999

For several years following the implementation of MP1, there were no significant changes to basic retirement benefits and SDCERS earned strong investment returns. The City made contributions at the levels agreed to in MP1. The contributions made by the City under the terms of MP1 were less than the actuarially required level, i.e., the ARC, but the contribution shortfalls were masked by the strong investment returns. The System's members increased their participation in the DROP program. The System also

continued to cover the cost of other benefits such as the 13th check and retiree health insurance from Surplus Undistributed Earnings. During this period SDCERS used its reserves that had been established primarily in years in which investment returns were greater than the 8% assumed rate of return.

- a. Strong Investment Returns during 1997 – 1999 Lead to Additional Requests from the City Manager to Use Surplus Undistributed Earnings.

The bull market continued to generate significant investment returns on the SDCERS' investments as shown on the chart below.

Fiscal Year	Total Return ⁵⁶	Realized Rate of Return ⁵⁷	Net Investment Income ⁵⁸
1997	16.88%	9.57%	\$255,771,887
1998	14.62%	14.33%	\$278,681,878
1999	9.53%	9.70%	\$180,463,938

Source: SDCERS' 1999 CAFR, Investment Section

The performance of the investments also generated Surplus Undistributed Earnings, which were used to fund costs outside of the basic retirement and disability benefits (e.g., the 13th check paid to retirees and retiree health insurance. Surplus earnings were also used to pay SDCERS' administrative costs. As a result, the System costs were not reimbursed to SDCERS by the City).

Also during 1997 through 1999, City personnel and SDCERS' Staff continued to consider ways either to use the high investment earnings at that time or to save them for future use. One approach was to establish specific purpose reserves with some of these earnings. In advance of the June 1998 Board meeting, City Manager Mike Uberuaga proposed to the SDCERS' President creating three new reserves funded from Surplus Undistributed Earnings. Mr. Uberuaga described the reserves in a May 14, 1998 memo to Keith Enerson, SDCERS' Board President, as follows:

- Reserve to fund employer's contribution – This reserve was to be created with System assets to fund the difference between the actuarially determined

⁵⁶ Total return measures fund performance in terms of the aggregate change in the fund's market value from the beginning of the measurement period to the end of the measurement period.

⁵⁷ Realized rate of return measures the gains or losses from actual sales of assets plus income earned during the period relative to the average book value of assets during the period.

⁵⁸ Investment income is the net gain or loss from the sale of assets, dividends paid and interest earned.

employer contribution rates and the contribution rates established under MP1.

- Reserve to fund supplemental Cost of Living Adjustment (“COLA”) benefit – The City Manager recommended that a supplemental COLA be provided to certain retirees to be paid from a reserve created from undistributed earnings. The amount of the reserve, estimated to be \$35 million, was to be calculated by the System’s actuary to fund the benefit for the defined group of retirees.
- Reserve to fund a portion of employees’ contributions – As a result of the benefit increases implemented in connection with MP1, the employee’s contributions were scheduled to increase in fiscal years 1998 and 1999. The City agreed with the labor unions to pay part of this increase (.49% of payroll) from a reserve to be established from undistributed earnings. This was contingent on SDCERS agreeing to establish a reserve of \$35 million.

None of these items impacted the amount of actual City contributions. The reserve to fund employer’s contribution and the reserve to fund a portion of the employees’ contributions served no substantive purpose. The reserves created the impression that the contribution shortfalls were being covered when they were actually accounting entries that had no financial substance. The reserve to fund supplemental COLA benefits used assets that would otherwise have been available for already established benefits, resulting in an increased cost to the System for which the City made no additional contributions. The reserve to fund a portion of employee’s contributions reduced the amount of money paid into the System since it lowered the amount contributed by the employees with no corresponding increase in the City’s contributions. This request from the City once again placed SDCERS in the center of benefit policy issues since the benefits were contingent upon approval the establishment of these reserves by the SDCERS’ Board.

b. DROP Participation Increased

Several questions regarding DROP began to develop including (i) the appropriateness of the interest rate credited to DROP account balances and (ii) if it was “cost neutral” to the City. These matters are further discussed below.

The DROP program was a benefit created in connection with MP1. The City instituted the program on a trial basis on April 1, 1997. It became a permanent benefit on April 1, 2000. Members must meet the age and service eligibility requirements for retirement to enter DROP and then make an irrevocable decision to retire from the City within 5 years. While in DROP, participants continue to work for the City and receive their bi-weekly salary or wages. They also continue to receive health and other benefits. However, the DROP participant earns no additional creditable service, discontinues

retirement contributions and receives future retirement benefits based on the calculation performed at the time the individual entered the DROP program; furthermore, a DROP participant's monthly retirement allowances and cost of living adjustments are paid into a DROP account established for the participant. Other amounts deposited into the participant's account included participant and employer bi-weekly matching contributions of 3.05% of current salary, the 13th check paid to retirees and interest at 8%.

A practice has been in place since the inception of the DROP program to credit the participant's DROP account with 8% interest, consistent with the assumed rate of return on the System's investments. In recent years, questions have arisen as to whether this is an appropriate interest rate in light of actual investment returns, particularly in periods with low or negative overall returns. There have also been questions as to whether SDCERS should establish the interest rate or if that is a benefit policy decision which should be made by the City. Navigant Consulting understands that the current SDCERS' Board and fiduciary counsel are addressing these matters.

The DROP program was designed to retain experienced employees and to provide a relatively predictable timeline for succession planning. The City performed an analysis to determine if the DROP program is cost neutral. Based on a memorandum dated January 10, 2005, the City concluded that the DROP program, excluding the impact on SDCERS, positively impacted City funds and provided other benefits.

The DROP program became very popular and contributed to an increase in DROP and retirement allowances, as well as low employee turnover. These factors have an upward impact on the actuarially determined contribution rates, thus contributing to the shortfall between actual contributions and the ARC.

Due to the popularity of the DROP program, the System's actuary recommended a change to the retirement assumption for Safety employees. In its 1998 actuarial valuation, GRS stated that it:

"devoted significant time in analyzing data from DROP participants. There were 214 DROP retirees in the first fifteen months of the program. 72% of DROPs were Safety members. Their demographics vary significantly from non-DROP retirees. DROP retirees have much longer service (an average of 28.6 years) and much larger initial allowances (\$40,000+ average).

The heavy incidence of DROP retirees led us to make a recommendation during February's Investment and Business Procedures meeting to modify the retirement assumption for Safety employees.

City Fire and Police members will come very close to reaching the 90% maximum benefit with 30 years of service and attainment of age 55. For Safety

members attaining both thresholds, there is little incentive not to DROP unless one anticipates a significant pay increase.”

The SDCERS’ actuary, Mr. Roeder, recommended the actuarial change described above which the SDCERS’ Board did not adopt.

The June 30, 1999 actuarial valuation noted a net increase in DROP participants from 214 to 315, along with a marked increase in retirement and DROP allowances. The City was experiencing low employee turnover in non-DROP retirees, which resulted in higher attained age of participants and higher plan costs.

c. The City Continued to Contribute to SDCERS at Rates Less Than the Rates Calculated by the Actuary

Contributions continued to be less than the ARC recommended by GRS as shown in the following table.

Comparison of Actuarial Required Contributions (“ARC”) to Contributions Made

(000s)	1996	1997	1998	1999
Actuarial Required Contribution	\$29,106	\$33,481	\$40,154	\$42,478
Contribution Made	25,471	28,061	30,979	34,467
Contribution Shortfall	3,634 ⁵⁹	5,420	9,174	8,011
Percentage of ARC Contributed	88%	84%	77%	81%

Source: SDCERS’ 2001 and 2003 CAFR

An example of the impact on contributions as a result of MP1 can be seen in the June 30, 1996 actual valuation. This report issued by GRS was dated January 9, 1997. GRS calculated the ARC for fiscal year 1997 (i) based on the benefits granted in connection with the 1996 City Manager’s proposal and (ii) without the 1996 benefit increases. GRS calculated the ARC as a percent of payroll to be 10.87%. Based on an estimated payroll of \$381.5 million, the required contribution was \$41.5 million. Without the benefit increases, the ARC would have been 8.71% which would have resulted in contributions of \$33.2 million. In fact, the ARC percentage and dollar amount contributed by the City for fiscal year 1997 would have decreased from over 9.20% in 1996 without the benefit increases granted in 1996.⁶⁰ Under the terms of MP1, the City’s actual contribution rate

⁵⁹ The reduced City contribution rates from MP1 did not take effect until fiscal year 1997; however, the agreement provided for the City to pay a budgeted amount for fiscal year 1996 that differed from the ARC.

⁶⁰ The 9.20% ARC represented a weighted ARC for the Port and the City combined. The actual ARC for the City was greater since the Port ARC was less than 9.20%.

was set at 7.33%. Based on the same \$381.5 million estimated payroll this would have resulted in contributions of \$28 million, totaling \$13.5 million (over 30%) less than the ARC.

From the time SDCERS changed its funding method from EAN to PUC in 1991, there was a stated objective by the SDCERS' Board to return to EAN in the future. During the deliberations of MP1 this objective was reiterated.⁶¹

Beginning in at least the June 30, 1998 actuarial valuation, SDCERS requested that GRS calculate the ARC under EAN in its annual actuarial valuation. The actual contributions as well as the ARC determined using the PUC method grew further from the amount that would be contributed under the EAN method. As shown in the June 30, 1998 actuarial valuation,⁶² the ARC for fiscal year 2000 under EAN was 13.30% compared to 11.48% computed using PUC and the actual contribution rate from MP1 of 8.83%. Based on the estimated payroll in that valuation report of \$399 million, the additional contribution to achieve the EAN level would have been approximately \$7 million more than under PUC and approximately \$18 million more than the amounts to be paid under the MP1 rate.

Although the GRS actuarial valuations for fiscal years 1997, 1998 and 1999 stated that "the retirement system continues to be in sound condition in accordance with actuarial practices of level-cost financing," it began signaling potential issues in the 1999 actuarial valuation report. The UAAL increased 16% from \$128 million to \$148 million and the funded ratio declined from 93.6% to 93.2%. This decline could be viewed as insignificant except that it occurred in a year in which there was an actuarial gain of \$29.8 million. Despite this gain, the drop in the funded ratio highlighted the increase in unfunded liability.

Comment A included in the June 30, 1999 actuarial valuation identifies several items that impacted SDCERS' funded ratio including:

"The computed actuarial rate has increased from 11.48% to 11.96%. Due to the agreement in the City Manager's proposal, the amount funded was again significantly less than the computed rate. The City contribution rate...was 8.33% for the 1999 fiscal year end and is 8.83% for the 2000 fiscal year."

"Four factors having nothing to do with actual experience since the 1998 valuation put upward pressure on the computed rate: In addition to

⁶¹ During MP2, there were statements made that the increasing contribution rates adopted in connection with MP2 would achieve EAN after 2009.

⁶² The June 30, 1998 actuarial valuation, dated May 1999, included the City's contribution rates for fiscal year 2000.

contributing less than the computed rate, 34 million dollars was set aside for supplemental (a.k.a. "STAR") COLA benefits. Also, the second year of a three-year phase-in regarding lower employee turnover assumptions is in place. City-negotiated offsets against employee contribution rates continue to use much higher assumed employee turnover than indicated by 1990's experience. If none of these factors existed, the computed rate would have been 10.75%."

"Last, the popularity of the DROP program reduces active member payroll against which the amortization percentage for unfunded liabilities is based. When a fixed amount of unfunded liabilities are amortized against a smaller payroll base, a higher percentage results."

"As we indicated in last year's presentation, the computed rate will again increase next year if actuarial nirvana occurs whereby actual and assumed experience exactly coincide."

These signs foretold issues that would arise when the System no longer had strong investment returns and continued underfunding. The funded ratio remained above 90% throughout the late 1990's. It rose to 97.3%⁶³ as of June 30, 2000.

2. Corbett Litigation

On July 16, 1998,⁶⁴ a class action lawsuit, *Corbett v. City Employee Retirement System* (San Diego Super. Ct.) (No. 722449), was filed against the City and SDCERS alleging that retirement benefits were not properly calculated. This was initiated shortly after the California Supreme Court in *Ventura Deputy Sheriffs' Association v. Ventura County Employees' Retirement Association* concluded that compensation for the purpose of calculating pension benefits includes not only base salary but items such as overtime pay and accrued vacation. The Corbett litigation resulted in additional benefits for SDCERS' members for which the City did not increase its contribution rates to provide for those benefits.

a. Corbett Settlement

The Corbett litigation was settled on May 17, 2000. The settlement provided certain benefit enhancements to both active and retired SDCERS' members. More specifically, active members would be allowed to make an additional election at the time of their retirement by either increasing the retirement calculation factor or increasing their

⁶³ This funded ratio reflects the Board's decision to incorporate the cost of the non-contingent benefits associated with the settlement of the Corbett litigation. Without the liability associated with Corbett, the funded ratio was 105%.

⁶⁴ Plaintiffs filed the First Amended Complaint on October 28, 1998.

retirement benefit by 10%. Retired members receiving benefits were given a retirement benefit payment increase of 7%. The settlement agreement further provided that "Each year, these payments [to the retired members] are contingent on SDCERS having sufficient Surplus Undistributed Earnings to pay them....To the extent these amounts are not paid in any year because there are insufficient Surplus Undistributed Earnings, they will be carried forward as a contingent liability which will be paid in future years in which there are sufficient Surplus Undistributed Earnings to pay them under the statute."

b. Impact of Corbett Settlement on SDCERS

The Corbett settlement impacted SDCERS' actuarially determined liabilities and funding ratio. For active members, the benefit increases resulting from the Corbett settlement increased the unfunded liability by approximately \$185 million as of June 30, 2000.⁶⁵ The funded ratio without reflecting the Corbett benefit increases for active members would have been 105.0%, including the liability associated with the benefit lowered the funded ratio to 97.3%.

SDCERS instructed the actuary not to include the benefit enhancements granted to retired members under the Corbett settlement because they were deemed to be contingent. However, the contingency appears to only address the timing of the payment, not if the benefits will be paid. "If contingent liabilities were to be included, the funded ratio would drop to 94%."

In connection with the June 30, 2001 actuarial valuation, Mr. Roeder presented the valuation to the SDCERS' Board on February 15, 2002. He noted that the Corbett benefits labeled "contingent" were not included in the valuation. The actuarial valuation stated "We have NOT included any Corbett contingent liabilities in the valuation. If we had included the value of such liabilities, estimated to be in the \$70-76 million range, the funded ratio would drop in the 2-2.5% range."

GRS calculated in its June 30, 2000 actuarial valuation that the System's liabilities increased by approximately \$260.8 million as a result of the benefit enhancements under the Corbett settlement. Because the City's contribution was in accordance with the terms of MP1, the City did not make additional contributions to fund these benefit enhancements. Based on information included in the June 30, 2001 actuarial valuation,

⁶⁵ SDCERS' Board opted to have the actuary include the Corbett benefits in the June 30, 1999 actuarial valuation although the benefits were not effective until July 1, 2000, which is permissible under actuarial standards.

Navigant Consulting estimated that the City's contributions should have been increased by approximately \$17 million.⁶⁶

Further, at the February 18, 2005 SDCERS' Board meeting, the Board approved the inclusion of contingent benefits associated with the Corbett settlement in the actuarial valuation. As a result, beginning with the June 30, 2005 actuarial valuation, the contingent portion of the Corbett settlement will be included as a liability in the actuarial valuation.

Navigant Consulting became aware during some of its interviews that SDCERS has been calculating disability benefits using factors established in the Corbett settlement. The Corbett settlement and the resulting provisions added to the San Diego Municipal Code do not specifically address disability payments. Navigant Consulting understand that Mr. Grissom instructed SDCERS' Staff to reflect the Corbett settlement factors into the payment calculations. We have been informed that less than 150 members may have been impacted.

3. 2000 - 2001

The funded ratio of the System remained strong as of June 30, 2000 largely because of substantial investment returns earned in that fiscal year. The System's assets recognized an investment gain of \$291 million more than the assumed 8% benchmark resulting in a funded ratio of 105% without the Corbett non-contingent benefits and 97.3% with the Corbett non-contingent benefits. By the time the fiscal year 2000 CAFR and actuarial valuation were issued, the bull market had ended and the System was beginning to experience investment declines. The ongoing underfunding, additional benefits granted and actuarial losses that were not reflected in the City's contribution rates that had been previously overshadowed by the bull market began to contribute to a decline in the funded ratio over the next several years.

a. The Financial Markets Impacted SDCERS' Funded Status.

In the June 30, 2000 actuarial valuation, GRS acknowledged some of the underlying issues involved in the decreasing funding status. In Comment E, GRS stated:

"Ongoing, increased benefits to current retirees and current vested deferreds, due to the Corbett decision, are based on 'excess' investment earnings. Since the magnitude of such increases are [sic] large, this could have an impact on the appropriate rate of investment earnings assumed. If extra benefits are conferred

⁶⁶ This amount is calculated using the contribution rate associated with the Corbett contingent liabilities multiplied by the actuarial payroll and the ratio of the total Corbett liability to the Corbett contingent liabilities (1.1% x \$450 million x 3.5).

during the 'good' years, then the median, 'after the fact' investment return should theoretically be correspondingly lower."

It appears that Mr. Roeder was trying to highlight that the practice of paying for additional benefits from excess earnings during above average years would erode the average investment earnings trend to the point that the assumed rate of return may need to be lowered, which would increase the UAAL and would eventually require additional contributions.

SDCERS' financial condition continued to decline during fiscal years 2001 and 2002. The June 30, 2001 actuarial valuation reflected an actuarial loss of \$193 million and the funded ratio decreased from 97.3% to 89.9%. GRS acknowledged that half of the actuarial loss was attributable to investment losses and since the losses, like gains, are amortized over five years, only a small portion of the impact of the investment losses was reflected in the funded ratio. GRS also pointed out that "there will be larger investment losses on an actuarial basis next year unless the markets improve over the next five months," and warned of "Evidence of the brewing financial storm cloud...." Furthermore, the funded ratio would have been lower had all of the benefits granted in connection with the Corbett settlement been included. GRS noted:

"We have NOT included any Corbett contingent liabilities in the valuation. If we had included the value of such liabilities, estimated to be in the \$70-76 million range, the funded ratio would drop in the 2-2.5% range."

The contribution rates contained in the June 30, 2001 valuation were greater than those established under MP1. The actuarial contribution rate increased from 12.58%⁶⁷ for fiscal year 2002 to 15.59% for FY 2003⁶⁸, whereas the rates set under MP1 were 9.83% for fiscal year 2002 and 10.33% for fiscal year 2003. Contributing to the widening gap between actuarially determined rates and the rates being paid in accordance with MP1, were the benefits provided under the Corbett settlement. Gabriel Roeder Smith specifically raised a concern about the practice of attempting to fund new benefits with Surplus Undistributed Earnings in the "good" years.

The GRS actuarial valuation for the fiscal year ended June 30, 2001 continued to conclude that:

"Overall, the financial condition of the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing."

⁶⁷ Excluding the Corbett non-contingent benefits decreases the contribution rate to 8.35%.

⁶⁸ The June 30, 2001 actuarial valuation dated February 12, 2002, applies to the City's fiscal year 2003 contribution although the City's contribution rate was set by MP1.

GRS added additional language for the first time in this valuation as follows:

“However, we want all parties to be acutely aware that the current practice of paying less than the computed rate of contribution or pickup will help foster an environment of additional declines in the funding ratios in the absence of healthy investment returns.”

The actual contributions, as compared to the ARC, during this period as reported in the June 30, 2003 CAFR are shown in the table below.

(000s)	2000	2001
Actuarial Required Contribution	\$47,471	\$56,478
Contribution Made	\$38,701	\$43,385
Contribution Shortfall	\$8,771	\$13,093
Percentage of ARC Contributed	82%	77%

b. Purchase Service Credits Negatively Impacted SDCERS’
Funded Status

As discussed previously, City employees received a benefit in connection with MP1 which allowed them to purchase up to five years of additional service credit (known as “purchase service credit” or “PSC”). These credits were to be paid for at their actuarial cost plus interest. However, a simplified price structure used to calculate the price did not accurately reflect the true costs of the service credit. This program became more popular and economically beneficial to the members after the benefit formula improvements occurred in connection with MP2. As a result, this program contributed to the unfunded liability of the System.

SDCERS’ difficulties in tracking these purchases and reporting them to the actuary prevented them from realizing the magnitude of the losses being caused by these purchases. In the June 30, 2002 actuarial valuation, GRS reported a \$56.4 million actuarial loss on the PSC program because the liability created by these purchases was \$77.7 million, for which members paid \$21.3 million.

SDCERS’ Staff requested that GRS evaluate the current pricing of the PSC and recommend to the Board at the August 2003 meeting regarding the adequacy of the pricing. GRS recommended that the PSC be priced based on the member’s age at the time of purchase, which would lead to a more precise costing method. However, Mr. Roeder was directed to look at a flat rate as a result of previous Board and Committee discussions. Board members Ray Garnica and Mary Vattimo showed interest in the alternative calculation of using a member’s age at the time of purchase. Nonetheless,

there was an expressed desire by SDCERS' Staff to continue to use a single blended rate per member.

In its May 2004 actuarial audit, Mercer also identified the problem caused by not using the age of the member in setting the price of the purchased service. Navigant Consulting understands that the price was subsequently raised but did not vary by age of the member. Navigant Consulting further understands that there was a large number of new applicants before the increased rates went into affect causing a backlog of pending applications. SDCERS needed to extend the effective date of the price increase. GRS reported in its June 20, 2004 actuarial valuation that it expected one more year of losses related to this program.

During the year ended June 30, 2003, 1,338 active General members purchased a total of 6,157 years of service and 268 Safety members purchased a total of 948 years of service. During the year ended June 30, 2004, an additional 1,909 General members purchased 8,890 years of service and an additional 454 Safety members purchased 1,305 years of service. The resulting liability for the service credits purchased during the fiscal year ended June 30, 2004, was \$92.4 million for which the System received \$65.3 million, resulting in a loss of \$21.7 million. Although the June 30, 2003 actuarial valuation did not separately report the amounts, the unfunded liability increased as a result of the PSC. These two years along with the cumulative losses recognized in 2002 result in a combined increase to the UAAL of over \$100 million.

Ron Saathoff purchased five years of creditable service under the PSC program. He applied to purchase this service in July 2000 and SDCERS prepared contract at that time. There was a misunderstanding between Mr. Saathoff and Vincent Hayes, then SDCERS' Operations Manager, as to who was waiting for whom to initiate the contract. In April 2002, Mr. Saathoff inquired about his PSC. SDCERS' personnel prepared a new contract which contained a higher cost given his increased salary since 2000. Mr. Saathoff insisted that the purchase be honored at the April 2000 contract terms rather than his then current salary. The difference in the cost was \$18,141 per year based on his 2000 salary and \$20,814 per year using his 2002 salary, a total difference of \$13,365. He attributed the delay and added cost to an administrative error by SDCERS' personnel and because there had been other instances where members were not penalized due to SDCERS' errors. SDCERS allowed Mr. Saathoff to purchase the service credits at the lower cost.

- c. The Mayor Commissioned the Blue Ribbon Committee to Evaluate the City's Finances, Including SDCERS.

In April 2001, the Mayor created the Blue Ribbon Committee on San Diego Finances consisting of nine individuals from the City and private sector,⁶⁹ to (i) perform an independent evaluation of the fiscal health of the City, (ii) review budgeting principles of the City, and (iii) report findings and recommendations to the Mayor. The Committee selected six fiscal areas to examine, including retirement benefits and unfunded pension liabilities.

The Blue Ribbon Committee issued a report to the Mayor in February 2002. Among other items, the report included two recommendations regarding retirement benefits. The Committee recommended (i) a change in the City's funding strategy to one that results in the City fully funding its future obligations earned today which includes the pension benefits as well as the retiree health benefits and (ii) the City obtain a current and comprehensive analysis of projected pension expenses and revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances.

The Blue Ribbon Committee requested that the City respond to its recommendations, and the City in turn requested that SDCERS respond to the retirement recommendations by June 2002. The SDCERS' Board requested at least one extension of the deadline and presented the response in February 2003. The SDCERS' Board members received a draft of SDCERS' responses at the January 2003 Board meeting. Mr. Pierce and Mr. Grissom presented SDCERS' responses to the City Council on February 12, 2003. Mr. Pierce and Mr. Grissom presented that SDCERS' maximum projected liabilities were approximately \$2 billion, of which only \$720 million represented the unfunded pension liability as of June 30, 2002.⁷⁰

The Blue Ribbon Committee recognized that the City was deferring its costs for pension and retiree health benefits and raised its concerns at the same time the City and SDCERS' Staff began to realize that the System's funding floor, as established in MP1, may be reached. Three months after the Blue Ribbon Committee issued its report, the City exacerbated the problem by proposing MP2 in response to concerns about falling below the funded ratio.

⁶⁹ None of the committee members served on the SDCERS' Board or were SDCERS' Staff during their time on the committee.

⁷⁰ Diann Shipione created a presentation to respond to SDCERS' presentation. It said that 85% of the \$720 million unfunded pension liability was attributable to investment losses although the 85% is not described in Mr. Grissom's presentation or in the meeting overview.

The table below shows the history of SDCERS' AAL, UAAL and funded ratio at the time the City began the 2002 meet and confer process with the labor unions.

(000s)	06/30/96	06/30/97	06/30/98	06/30/99	06/30/00	06/30/01
Valuation Assets	\$1,480,772	\$1,632,361	\$1,852,151	\$2,033,153	\$2,459,815	\$2,525,645
AAL	\$1,620,373	\$1,748,868	\$1,979,668	\$2,181,547	\$2,528,774	\$2,809,538
UAAL	\$139,602	\$116,507	\$127,517	\$148,394	\$68,959	\$283,893
Funded Ratio	91.4%	93.3%	93.6%	93.2%	97.3%	89.9%

F. City Manager's Proposal 2

1. MP2 Factual Conclusions

a. MP2 Continued the City's Underfunding to the System

The SDCERS' Board again approved a change in the way the System would be funded, continuing the underfunding to the System that resulted from the first City Manager's Proposal. Additionally, the increased costs from benefit enhancements exacerbated the System's funded status.

b. Impact of MP1 Trigger

As early as the end of calendar year 2001, it was clear that Mr. Grissom and City personnel were concerned about the funded ratio and reaching the trigger established by MP1. Continuing investment declines throughout the end of fiscal year 2002 increased the likelihood that SDCERS' funded ratio would drop below the 82.3% trigger. The June 30, 2002 actuarial valuation reported a funded ratio of 77.3%.

Although there were conflicting views of the impact of the trigger, the parties worked to avoid the implications of the trigger. MP2 retained the 82.3% trigger, but it permitted the City to make payments under the ARC rates over a five year period.

c. The City Again Placed SDCERS' Board in the Center of the City's Benefit Policy

MP2 was another situation where the City placed SDCERS in the center of benefit decisions. The reason for MP2 appeared to be the City's desire to avoid triggering a balloon payment to SDCERS that was included in MP1.

d. Concerns Raised about City Deferring Contributions to the Future

The SDCERS' Board disregarded concerns raised by some Board members and concerns initially raised by its actuary and fiduciary counsel. These concerns were not properly addressed by fiduciary counsel during Board meeting discussions when these concerns were raised but rather, months after the introduction of the proposal.

e. Board Did Not Analyze and Discuss the City's Ability to Pay

In connection with MP1, fiduciary counsel advised the Board to evaluate the creditworthiness of the City. The Board's new fiduciary counsel for MP2 did not provide the same advice. Navigant Consulting is not aware that the Board analyzed or discussed the City's future ability to make up for the contribution shortfalls.

f. Board Members Served Dual Roles

Some Board members served dual roles as System members who received SDCERS' benefits, union designees who represented the union members or City employees with responsibilities to City management or City officials. The current Board structure has attempted to alleviate this problem to some degree as a majority of the Board members are not System members or City employees.

g. Two Board Members Received Unique Benefits

Ron Saathoff received the presidential leave benefit based on both his City-paid salary and union stipend, thereby increasing his annual retirement benefit. Terri Webster was part of a small group of City employees who were not subject to a cap on their retirement benefits set at 90% of salaries, thereby increasing their annual retirement benefits.

h. Reliance on Fiduciary Counsel and Actuary

At the June and July 2002 Board meetings, fiduciary counsel, Bob Blum, raised concerns with the initial MP2 proposals, but ultimately supported MP2. It is unclear why Mr. Blum's position changed and the Board members apparently did not ask him the reason for the change.

SDCERS' actuary, Rick Roeder, also raised concerns with the MP2 proposal during June and July 2002. In July 2002, the actuary provided projections showing that MP2 resulted in large increases to the City's contribution rate. In November 2002, Mr. Roeder issued a

letter in connection with MP2 which contained concerns but did not state a position either supporting or opposing MP2.

2. Overview of 2002 City Manager's Proposal

Under the 1996 City Manager's proposal, the City agreed to pay an "amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation." In early 2002, the City faced a possibility of a balloon payment of at least \$25 million as the Retirement System funding ratio neared the trigger established in MP1. As the stock market declined impacting SDCERS' investments and the SDCERS' funding ratio decreased, the City contingently agreed to improved benefits for its employees during the 2002 meet and confer process. This benefit increase, coupled with the impending balloon payment, lead the City to seek contribution relief from the System. The result was a second City Manager's proposal, which allowed the City to continue funding the System at less than the actuarially determined amount simultaneous with increased retirement benefits.

3. City Sought Contribution Relief for Impending Balloon Payment

On May 29, 2002 at a special meeting of the SDCERS' Board, the City Manager, Michael Uberuaga, first broached a new City Manager's proposal with the full Board to be discussed at the June 2002 SDCERS' Board meeting that would supersede the City's contribution rates as set in the 1996 City Manager's proposal. He stated the new proposal would introduce lowering the funding floor to 75%. By that time, the City had already entered into tentative 3-year agreements with labor unions to increase retirement compensation contingent upon the approval of the new funding floor.

In Mr. Uberuaga's June 10, 2002 proposal, he stated: "In an endeavor to meet converging interests and time lines, the City agreed to benefit enhancements through labor negotiations which have impacts on retirement funding, and consequently these benefit enhancements were offered contingent upon successfully addressing the potential "trigger" in the 1997 Manager's Proposal". In addition to lowering the funding floor to 75%, he proposed creating a new trust and transferring \$25 million from the \$100 million contingency reserve from FY 2000 earnings to the new trust to fund retiree health benefits and using the employee contribution reserve to increase the amount of City pickup in employee contributions. Mr. Uberuaga sought immediate Board approval.

4. Results of 2002 Meet and Confer Process

The 2002 meet and confer process resulted in agreements between the City and the labor unions to increase retirement benefits, among other things. The City recognized it needed the support of the unions to obtain funding relief and the unions recognized this need which the unions used as leverage to bargain for increased benefits. The City

reached agreement with three of its labor organizations on May 13, 2002. SDCERS' Staff moved ahead with implementing the changes necessary to administer the new benefits with an effective date of July 1, 2002 prior to the approval of the City Manager's proposal. By July 11, 2002, SDCERS' fiduciary counsel and City Attorneys had already drafted agreements between the City and labor unions to increase retirement benefits. MOUs were communicated to at least the MEA and Local 127 union members after the July 11, 2002 SDCERS' Board meeting.

5. MP1 Trigger

Increased retirement benefits for the union members were contingent upon the City reaching an agreement with SDCERS. This agreement would eliminate the balloon payment as a result of hitting the trigger set forth in the 1996 City Manager's proposal. Under MP1, the mechanism of the trigger required the City to fund an amount sufficient to up to a funded ratio of 82.3% (i.e., a balloon payment the amount of which would have depended upon how far below the trigger the funded ratio fell as of June 30, 2002).

"In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation."

In other words, when the funded ratio reached 82.3% (the funded ratio at the June 30, 1996 was determined to be 92.3%) the City would be required to make a one-time payment to bring the funded ratio back up to 82.3%. Navigant Consulting determined this amount to be approximately \$160 million using the June 30, 2002 actuarial valuation.

a. Interpretation of Trigger

Although the language in MP1 stated that the City would contribute "the amount determined by the actuary necessary to restore the funded ratio...", there were varying interpretations of the consequences of hitting the trigger that may have caused debate among Board members. One interpretation by SDCERS' Administrator, Larry Grissom, and the City's Human Resources Director, Cathy Lexin, known as the "Grissom/Lexin" interpretation, required the City's contribution rate to increase to the full actuarial rate the following fiscal year in which the 82.3% trigger was hit. Another interpretation stated by SDCERS' fiduciary counsel, Bob Blum, required the City to make a lump sum payment to reach the 82.3% ratio. A third interpretation made by Board member Sharon Wilkinson at the July 11, 2002 Board meeting, also known as 'Fred's theory' (referring to

Fred Pierce in Richard Vortmann's memo to the Board dated June 24, 2002), was that the City would ramp up its contributions up to the 82.3% funding level over five years. Regardless of how or when funding would be restored, the City was not prepared to make the necessary increased payment. The City's focus on revising MP1 to avoid either the increased contribution rate or the balloon payment should have been a signal to the Board of long-term funding problems.

In his November 18, 2002 opinion letter to the Board, Mr. Blum, stated that there was "potential controversy" over the meaning of the MP1 trigger. In contrast, the interpretation of the trigger was clearly defined in his June 12, 2002 draft opinion letter. There he stated: "A safeguard clause was included in the Manager's Proposal, and was strengthened to protect the funding status of SDCERS at the request of SDCERS' fiduciary counsel and actuary. The safeguard provided that if the funding status of SDCERS falls more than 10 percentage points below the then current ratio – that is, falls below 82.3% - in the following year the City would contribute enough to SDCERS to bring the ratio up to 82.3%." In an attempt to add clarity, he stated in the corresponding footnote:

"For example, if the funding ratio were to fall to 80% as of June 30, 2002, then for the fiscal year July 1, 2003 – June 30, 2004 we understand that, under the current Manager's Proposal, the City would increase the scheduled contribution by an amount that would bring the funding ratio to 82.3%. We also understand that this require an extra contribution in the 2004 fiscal year, above the scheduled contribution, of about \$75 million based on current data."

Mr. Blum also expressed this view at the June 21, 2002 Board meeting when he stated that his understanding was that if the funding ratio goes to 80%, in the next year the City would have to make the same contribution that is on the schedule listed in MP1, plus \$75 million.

Although there was disagreement on applying the trigger, there was little discussion and no financial analysis or projections using the interpretation that a balloon payment would need to be made. Given that the precise funded ratio was not known during the time period MP2 was proposed and discussed, the amount of the balloon payment could not be precisely quantified. Mr. Roeder advised the Board that if the funding ratio fell to 80%, the balloon payment would be approximately \$75 million. Based on the actual funded ratio in the June 30, 2002 actuarial valuation of 77.3%, the City needed to contribute \$160 million to return the funded ratio to 82.3%. The City could have considered steps necessary to make this contribution including the issuance of pension obligation bonds or asset sales. There was no documentation of such consideration in the SDCERS' Board minutes or other SDCERS' correspondence reviewed in connection with Navigant Consulting's investigation. In its draft report dated April 16, 2003, after

MP2 was approved, the concept of pension obligation bonds was one of the alternatives explored by Public Financial Management.

Navigant Consulting also noted little discussion by SDCERS' Staff, Board members and advisors about the balloon interpretation of the trigger or consideration given to requiring the City to adhere to the original MP1 agreement based on this interpretation. The Board discussed the differing interpretations and possible difficulties in enforcing the balloon requirement on the City. Navigant Consulting was told that one of Mr. Blum's reasons for supporting MP2 was that it would provide more funds to SDCERS sooner than if it tried to enforce the balloon payment on the City and litigation ensued. Navigant Consulting is not aware of any legal analysis regarding this consideration at the time.

b. Discussions Around Trigger

One of the key questions regarding the MP1 trigger was when it was known that the funded ratio fell below 82.3%. The SDCERS' investment portfolio began to experience investment losses beginning in fiscal year 2001. The SDCERS' CAFR for the year ended June 30, 2001 reported an investment loss of \$50 million and total return of -.045%. The June 30, 2001 actuarial valuation showed that the funded status declined from 97.3% to 89.9%. City personnel and SDCERS' Staff were concerned about the funded status as early as late 2001 when additional investment losses were incurred. There was correspondence among Larry Grissom, Terri Webster, Cathy Lexin and Ed Ryan about these losses and the resulting impact on the payment of certain benefits and the funding ratio.

There was some discussion about the trigger in Board meetings leading up to and during the period MP2 was discussed as follows:

- February 15, 2002 - Mr. Roeder presented the results of the June 30, 2001 valuation and he pointed out that the funded ratio dropped to 89.9% and reminded the Board about the 82.3% trigger.
- March 15, 2002 - Ms. Webster raised concern about investment earnings as it might impact the funded ratio stating that "it is important for the City to know where this is headed...."
- April 19, 2002 – "Mr. Grissom said that a funding ratio of 84% is probable and could actually be worse due to actuarial losses on investments for the '02 fiscal year."
- May 29, 2002 – There were no specific comments in the minutes about the funded ratio although "Mr. Uberuaga said the matter at hand is a request to amend the

trigger that is in the System stating if we get below 82.3% where the City would be required to pay additional money.”

- June 21, 2002 – In response to a question about the anticipated 2002 funding ratio Mr. Roeder stated that “it would be a reasonable guess to say that you might be looking at something in the 80 to 84 percent area.” Mr. Roeder also made statements about the fact that the June 30, 2001 funded ratio based on EAN was 84.6%.
- July 11, 2002 – Although there was extensive discussion about what would happen if the 82.3% trigger were hit, there was little discussion about whether it was hit as of June 30, 2002. Mr. Roeder indicated that there was a probability the trigger would be hit as of the June 30, 2002 valuation. Mr. Roeder also said “...if the market malaise continued through 6/30/03...the 75 percent target could be hit say as of 6/30/03.” Mr. Roeder presented graphs and analyses which showed the funded ratio to be above 80% but it cannot be determined from these graphs whether the estimate he prepared was above or below 82.3%.

In Navigant Consulting’s interview of Larry Grissom, Mr. Grissom said that by February 2002 he and Mr. Roeder had discussed that the funded ratio would fall close to the trigger by June 30, 2002. He stated that they had several discussions about the ongoing investment losses over the next several months. Mr. Grissom stated that he instructed Mr. Roeder not to discuss the funded ratio with others since it was uncertain until the June 30, 2002 actuarial valuation was completed.

Navigant Consulting also addressed this matter with Mr. Roeder during his interview. Mr. Roeder stated that he was in the best position to know whether the funded ratio trigger was hit and he did not know with any certainty during the June and July 2002 time period. He said that he did not know definitively until he had received all of the necessary financial and member demographic information from SDCERS and the City to prepare the actuarial valuation. The valuation dated January 9, 2003, which he said was one of the earliest dates GRS had issued a valuation report for SDCERS. He also noted that a draft report would not have been complete more than a week in advance of the issuance of the final report. Mr. Roeder sent an email to Mr. Grissom on October 10, 2002 discussing the June 30, 2002 valuation (in process). By this point, GRS appeared to have had information about the assets noting that they decreased from \$2.67 billion to \$2.59 billion and experienced an actuarial loss of \$327.9 million. Mr. Roeder concluded this email by noting, “If the City accrued liabilities are \$3 billion, the funded ratio will likely be in the 80-82% range.” When the final June 30, 2002 valuation report was issued the valuation assets were \$2.44 billion, accrued actuarial liabilities were \$3.17 billion, the actuarial loss was \$365 million (of which investment experience represented \$313 million) and the funded status was 77.3%.

6. Involvement of City Personnel, SDCERS' Staff, Fiduciary Counsel, Actuary and Board Members

It appears that Ms. Lexin and Mr. Grissom developed a strategy to obtain SDCERS' Board approval for MP2. Mr. Grissom requested fiduciary counsel to prepare a legal opinion and the SDCERS' actuary to prepare an analysis prior to the June 21, 2002 Board meeting. Mr. Grissom coordinated with Ms. Lexin on these letters to the Board. In Ms. Lexin's memo on June 14, 2002 to the Mayor and City Council, she stated:

"Based upon conversations with the Administrator this week, it appears that the Board's outside fiduciary counsel is 'uncomfortable' expressing an opinion that approval of this proposal is within the Board's reasonable discretion as fiduciaries of the System."

In light of the negative opinion from SDCERS' fiduciary counsel, Ms. Lexin directed the proposal to be changed by requesting that the City's ramp up in contribution be revised from 0.50% to 1.00% a year.⁷¹ Her letter stated:

"It is clear that the current arrangement whereby the City's contribution rate increases by a fixed 0.50% per year will not accomplish full funding as contemplated in the plan."

"Therefore, it is recommended that the City Council authorize the City manager to amend the proposal to be presented on June 21, 2002, by increasing the annual increase in City contribution from 0.50% per year to 1.00% per year beginning in FY05."

This was made a permanent change in the June 18, 2002 revised City Manager's proposal by Deputy City Manager, Bruce Herring. Mr. Herring recommended in the proposal that the agreement sunset on June 30, 2009. Additionally, he recommended "that the City and SDCERS' Administrator and actuary continue discussions over the next six months to develop a long term, comprehensive funding policy."

As Mr. Grissom continued to work with fiduciary counsel, Mr. Blum, on his opinion letter, Mr. Grissom informed Ms. Lexin of progress that would affect the outcome at the July 11, 2002 Retirement Board meeting. They used this information to obtain other permanent changes to the City Manager's proposal that were introduced by Mr. Saathoff in a substitute motion at the July 11 meeting. In a subsequent memo to the Mayor and City Council dated July 8, 2002, she stated:

⁷¹ Using the fiscal year 2003 valuation payroll contained in the June 30, 2002 actuarial valuation, this increase represented an increase to the City's contribution of approximately \$2.4 million.

“While we still have not seen the fiduciary counsel’s final report, conversations with the Administrator lead us to be optimistic about a favorable report. The Manager’s Office intends to present the modified proposal at the SDCERS meeting of July 11, and respond to any addition questions which may arise.”

Ms. Lexin continued with:

“Based on our conversations with the Administrator, we anticipate a motion from a Board member which would further modify the proposal before the Board, by eliminating the request to lower the funded ratio floor, and including the five year phase-in if the trigger (82.3% funded ratio) is effectuated.”

After the substitute motion was made at the July 11, 2002 Board meeting, the Administrator, SDCERS’ Staff, City Manager, SDCERS’ fiduciary counsel and actuary continued to work together on the City Manager’s proposal. Larry Grissom collaborated with SDCERS’ Staff, fiduciary counsel and the SDCERS’ actuary on their letters. Mr. Blum and Mr. Grissom then worked with Rick Roeder to draft Mr. Roeder’s letter to the Board. In an email exchange between the three parties regarding Mr. Roeder’s letter, Mr. Blum wrote:

“Rick, you had signed off on this exact language before. So lots of people would be very unhappy if you are unwilling to sign off on it now.”⁷²

Mr. Roeder responded:

“I can live with the language just not optimum. No huge deal at my end.”

Mr. Grissom stated that he did not direct Mr. Roeder or Mr. Blum to reach a prescribed opinion but did tell them to formulate an opinion and state it clearly one way or another.

During the course of the investigation, Navigant Consulting identified limited involvement by Lori Chapin in MP2. Based on the interview of Roxanne Story Parks, Assistant General Counsel, Ms. Chapin and her staff in the SDCERS’ General Counsel’s office, recused themselves from providing advice to the Board regarding MP2 due to the personal benefit the individuals would receive from the enhanced benefits.

Meanwhile, City Attorneys drafted the agreement between the City and the Board by collaborating with Bob Blum to ensure that provisions on the City Manager’s proposal were captured accurately. Specifically, Assistant City Attorney Les Girard, assigned

⁷² Written in response to Mr. Roeder’s concern over the language “then the transition period is reasonable”.

Elmer Heap to draft the agreements with Mr. Blum. According to Mr. Heap, he was told by Mr. Girard that the assignment was of utmost importance and timing was critical.

7. Discussions at SDCERS' Retirement Board Meetings

a. June 21, 2002

When the proposal was discussed publicly at the June 21, 2002 Board meeting, Board members, actuary and fiduciary counsel alike voiced enough concern over the implications of the proposal that caused the motion to be continued to a future meeting. Mr. Roeder, warned the Board to be cautious when enhanced benefits were introduced at the same time as contribution relief. He also warned of the increasing gap between EAN/PUC rates and the City's contribution levels. He expressed concern over SDCERS' funding status. Mr. Blum stated that a judge could find the approval of MP2 not a prudent exercise by the Board as new developments in law have strengthened a Board's responsibility to ensure integrity and security of the financial status of a fund. He advised the Board to conduct due diligence to fully understand the implications of the proposal and not to negotiate benefits. Although the proposal was expected to be approved by SDCERS at this meeting, it was delayed for additional consultation and review by SDCERS' actuary and fiduciary counsel. Although a motion was made to approve the proposal, there was extensive discussion and concerns raised by Board members and no vote was taken. Instead, it was voted that "the president schedule a special meeting within the next two weeks and during that time period, that any Trustees submit their concerns to staff so the Board will be prepared to make a decision on this item as soon as possible."

b. July 11, 2002

After much discussion at the July 11th meeting surrounding the actuarial analysis provided by Mr. Roeder, (see Actuary Analysis below), Ron Saathoff proposed the amended motion developed by Ms. Lexin and Mr. Grissom. The motion included the following provisions:

- Allow the City's repayment schedule to be the difference between the current rate and the actuarial PUC rate if the 82.3% trigger is hit.
- This amount would be phased in incrementally on an annual basis from that point to 2009.
- This modification would be based on the current actuarial projections with the City to increase its contribution rate 1.00% per year.
- The City would reach the PUC rate in 2009 as included in the first City Manager's proposal sunset language.
- Transfer \$25 million into the Health Care Trust to pay retiree health benefits without lowering the funding floor to 75%.

- Provisions are contingent upon a written agreement between the City and Retirement Board.

Although it appears that Ms. Lexin drafted Ron Saathoff's substitute motion, she urged the Board to consider the original proposal with a 75% funding floor. Mr. Herring also encouraged the Board to vote on the City Manager's proposal as benefit increases were to be effective for the pay period ending July 15, 2002 and to vote in favor of it by stating that future benefits would not incur any additional unfunded liabilities.

Mr. Saathoff's substitute motion was passed in an 8-3 vote. Board members Tom Rhodes and David Crow voted against the proposal while Ray Garnica abstained. Mr. Crow was not comfortable voting on the motion, stating that approving it would be premature. Mr. Garnica stated that although the ideas were good, he did not feel the Board should rush into action and would prefer the Board to consider further analysis of the situation. Richard Vortmann and Diann Shipione left the meeting prior to the vote but had previously expressed their opposition to the proposal. Mr. Vortmann said the City caused problems by not paying its bills when it incurred the costs and the vicious cycle of providing City rate relief was becoming harder to break. Ms. Shipione did not feel it was necessary for the Board to vote on the proposal that day and like Mr. Garnica, would have preferred more time to evaluate the funding scenarios. As the proposal was contingent upon a written agreement between the City and the SDCERS' Board, the City Manager's proposal was not officially adopted until the Board meeting on November 15, 2002.

During the July 11, 2002 meeting, Michael Aguirre, an attorney in private practice at the time, issued a letter to the Retirement Board dated June 20, 2002 threatening a lawsuit for breach of fiduciary duty if the Board approved the original proposal. As a result, the Board raised the question of indemnification for its actions. Board President Fred Pierce stated that the City and Board could agree to indemnify trustees in any lawsuits arising out of actions taken by the Board. Cathy Lexin stated that the City Charter could be amended to allow indemnification of Board members under the City's policy. The indemnification issue was ultimately brought before the City Council on November 18, 2002 and passed. The City Charter was subsequently amended. The fact that Board members felt a need for indemnification may an indication that they had concerns about MP2.

c. Activity Between July 11, 2002 and November 15, 2002

Between July 11, 2002 and November 15, 2002 while Mr. Grissom, Mr. Blum, Mr. Roeder, and City personnel worked together in finalizing the agreement, discussion around the City Manager's proposal at the Board meetings ceased. The only mention of the City Manager's proposal was made at the October 18, 2002 meeting by Ms. Lexin,

who inquired from Mr. Blum whether his opinion on the proposal would be ready in two weeks.

During this period, the City Council approved the MOUs between the City and the labor unions. Navigant Consulting understands that at the October 21, 2002 City Council meeting,⁷³ the City Council unanimously approved the benefits negotiated during the 2002 meet and confer process. During the interview of Ann Smith, counsel to MEA, Ms. Smith explained that after October 21st, the MOU became a binding agreement with no contingencies. She further explained that if the City had reneged after October 21st, MEA was entitled to injunctive relief. However, if the City had reneged prior to the unanimous approval on October 21st, Ms. Smith would have only been able to pursue an unfair labor practice charge against the City. According to her, the benefits in the approved MOU were a “done deal” regardless of SDCERS’ Board approval of the 2002 City Manager’s proposal.

d. November 15, 2002

Ultimately, the SDCERS’ Board approved MP2 on November 15, 2002, and the City Council approved it on November 18, 2002, five months after its introduction. The motion to approve was put forth by Ron Saathoff and seconded by Ray Garnica. It was passed in a 10-2 vote. Diann Shipione and Tom Rhodes voted in opposition. Ms. Shipione stated the City’s request for funding relief was linked to increased benefits, which she thought was “unethical, if not outright corrupt.” It is unclear from Mr. Rhodes’ statements during the November 15, 2002 Board meeting why he voted against the proposal.⁷⁴ During Mr. Rhodes’ testimony at the preliminary hearing on November 30, 2005, he testified that he voted against the proposal because it was inappropriate for the Board to be involved with a proposal that set benefits.

8. Actuary Analysis, Legal Opinion, and Board Members’ Concerns with MP2

a. SDCERS’ Actuary Analysis

During the June 21, 2002 Board meeting, Mr. Roeder made a presentation in which he highlighted concerns he had about MP2. Some of the key concerns he cited are listed below.

⁷³ Navigant Consulting understands from Ann Smith that the City still had to do the second reading of the ordinance to change the San Diego Municipal Code to conform to the MOU. She also said that the participants needed to vote for the changes to become law.

⁷⁴ Mr. Rhodes’ primary comment at the July 11, 2002 Board meeting was “...it’s way improper for a trustee to make a proposal that’s their job to do. I don’t think that’s the role of a trustee at all.” He made little to no comment at the November 15, 2002 Board meeting.

- The SDCERS' Board should be cautious about enhanced benefits at the same time as contribution relief.
- The SDCERS' Board should be independent of setting benefits levels.
- Existing benefit levels are below average compared to other public systems in California or nationally.
- SDCERS has one of the lowest funded ratios on an EAN basis in California.
- The funded ratio is the lowest it has been since the 1980s.
- The gap between the computed PUC actuarial rate and the City contribution rate has been growing since the implementation of MP1.
- MP1 did not contemplate subsequent benefit increases.

Mr. Roeder provided graphs that showed the widening gap between City contributions and the actuarially determined rates under PUC and EAN and the declining funded ratio. His presentation elicited much discussion at the meeting.

Mr. Roeder, with input from Mr. Grissom and Mr. Blum, prepared an analysis to show the impact of two proposals for MP2 as compared to the "original manager's proposal," which did not reflect a balloon payment. This presentation was made to the SDCERS' Board at the July 11, 2002 meeting. The presentation included four scenarios: 8% Actual Earnings, 8% Actual Earnings With "Pipeline," 4% actual earnings, and 12% actual earnings showing City contribution percents and dollars, and funded ratio reflecting actual results through 2001 and projections for 2002 through 2009. The scenario with "pipeline" was the only one that reflected the methodology actually used by the actuary for purposes of preparing the actuarial valuation. The term "pipeline" referred to the practice of smoothing investment gains and losses over a five year period. GRS consistently used this practice during its tenure as SDCERS' actuary. It is unclear why three of the scenarios did not reflect this practice, even though that is what had been used and would continue to be used to determine the funded ratio and City contributions. The notes at the bottom of the three scenarios based on actual earnings stated that they did not reflect a \$225 million "negative pipeline," which would be incorporated into the valuation over the next four years. Navigant Consulting noted that Mr. Roeder originally proposed preparing four interest rate scenarios consisting of 0%, 4%, 8% and 12%. In Navigant Consulting's interview of Mr. Roeder, he stated he could not recall why the scenarios presented were different from what he originally proposed.

The projections, other than the 12% earnings scenario, showed the funded ratio declining below 80%. Each of these scenarios showed modest increases in City contributions in terms of percent of payroll as well as dollar amount for the first few years after 2002, but then rapidly escalating contributions thereafter. The scenario based on 8% with pipeline showed that City contributions under the revised MP2 would grow from \$48.4 million in 2002 to over \$100 million by 2006 and over \$200 million by 2008.

Mr. Roeder did not include the Corbett contingent liability, reserve accounts, or administrative expenses in his projections. As justification for his assumptions, Mr. Roeder stated: "Any time you have any benefit which will siphon off money during your good years, retiree medical or some other benefit, what they call shaving off the mountain tops. If you're taking off money during the good years, other things equal, that should lower your long-term expectation of the (years remaining to finance the) pension benefits."⁷⁵

Mr. Roeder subsequently sent a letter to the Board dated November 5, 2002. His letter contained approximately ten statements, but was unclear in his support of the proposal. For instance, his first point stated that the agreement "provides for better funding of SDCERS than does the existing Manager's Proposal, if the 82.3% trigger point is not hit," even though at this point in time it was apparent that the trigger was hit as of June 30, 2002. It also stated: "From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger." His final point stated that the Board may choose to support the proposal but his support was never clearly stated:

"If the Board decides that a transition period [to ramp up contributions to the PUC and/or EAN rates] is needed, then the transition period chosen is reasonable as the City will commit to contribute an additional amount each year starting in July 2004; if the 82.3% accelerated funding trigger is hit the ramp up to full PUC rates will be accelerated; the City will continue the full PUC rate starting in July 2008; the entire agreement will sunset on June 30, 2010; and the City and Board agree to move to the EAN rate rapidly after that date."

b. SDCERS' Fiduciary Counsel Opinion

In connection with approving MP2, the SDCERS' Board requested an opinion of fiduciary counsel, Bob Blum. Mr. Blum corresponded with Mr. Grissom, on his opinion letter⁷⁶ that would later be discussed and relied on by Board members. He sent Mr. Grissom, Ms. Chapin, and Mr. Roeder, a draft version of his letter dated June 12, 2002.⁷⁷ In his draft opinion letter, Mr. Blum stated a number of concerns, including the System's funded ratio was the lowest it had ever been in 14 years. Together with the continued

⁷⁵ "...years remaining to finance the..." was noted as inaudible in the July 11th Board meeting transcript but quoted in the July 11th Board meeting minutes.

⁷⁶ During the Gleason litigation, SDCERS' Assistant General Counsel sent an email to SDCERS' General Counsel that Mr. Grissom had notified Mr. Blum and his partner, Connie Hiatt, Seltzer Caplan wanted "to sue them for malpractice". During their interviews, Mr. Grissom said that was untrue and Ms. Chapin said that Mr. Grissom told her after the email that the statement was untrue.

⁷⁷ During Navigant Consulting's interview of Mr. Roeder, he stated that he did not deem any of his letters issued in connection with MP2 as an opinion letter for MP2.

expected volatility of the stock market and the increased costs associated with the Corbett settlement, "SDCERS will effectively have no 'surplus' earnings at the year ending June 30, 2002, to fund new benefits or to make up contribution shortfalls." Mr. Blum also expressed concerns regarding breach of fiduciary duties that included the following:

- "SDCERS funding status has fallen by an estimated 14 percentage points in the last two years and is the lowest in 14 years. It is estimated to be approximately 8 percentage points below the funding ratio in 1996. The contributions under the Manager's Proposal are less than the actuarially determined contribution rates under the annual actuarial valuation. The contributions under the Manager's Proposal (including member contributions) do not cover normal cost plus interest on past service liabilities."
- "In light of the current proposed amendment to the Manager's Proposal, it appears that neither of these key structural elements [safeguard floor and contribution ramp-up] of the Proposal works. The safeguard floor is not a safeguard precisely because the City has asked that it be lowered. Further, it appears that an important reason that the City has asked it to be lowered is that, under the existing structure, a substantial balloon payment may be required in the next three years, when the City wants stability for its budget."
- "In light of the current proposed amendment to the Manager's Proposal, it appears that the City's position as a borrower from SDCERS is not as strong as in 1996. This is precisely because the City has stated that it wishes not to meet its obligations under that Proposal, and instead wishes to renegotiate the agreement, or debt (which is now a greater amount) to alleviate financial hardship for the City. Such actions indicate the City's unwillingness or inability to budget in advance for anticipated obligations to SDCERS under the Manager's Proposal. Such actions at least raise questions about 'borrower's', or the City's, commitment to pay the contributions as promised in the Manager's Proposal, or in an amendment to such agreement. In light of the change in the funding status of SDCERS, the Board arguably must place greater weight on this issue since the 'debt' is much larger."

He summarized his opinion with:

"...it is our opinion that there is a material risk that a court would find that approval by the Retirement Board of the proposed amendment including the reduction in the 'floor' in the Manager's Proposal to 75% was not a prudent exercise of the Board's fiduciary responsibilities, particularly if insufficient mitigating actions were taken by the Board."

Mr. Blum's opinion changed in his November 18, 2002 opinion letter to the Board presumably as a result of the changes made to the City Manager's proposal. None of his original concerns, including the ones cited above, were mentioned in his final letter. Instead, his opinion of the City Manager's proposal was favorable. He concluded in this letter that "it is our opinion that it would be a reasonable exercise of the Board's fiduciary responsibilities if the Board entered into the Agreement." He advocated the proposal by stating:

- "The ramp up in City contributions under the Agreement is materially faster than under the existing Manager's Proposal unless the 82.3% trigger is hit and one of the 'high contribution' interpretations of the Manager's Proposal is enforced. However, it is not clear exactly what the existing Manager's Proposal provides in this regard. Further, it is not clear that the City would be able to pay the higher contributions required under the 'high contribution rate' interpretations. Further, under the Agreement it is clear when full PUC rates will be paid and it is also clear that there is a high likelihood that EAN rates will be achieved faster than under the current Manager's Proposal. Finally, all of the provisions of the Agreement are clearer than those of the current Manager's Proposal."
- "In essence, the Board decided to trade potential controversy over the meaning of the current Manager's Proposal and the possibility of receiving substantially higher contributions from the City if the 82.3% trigger is met in exchange for materially higher contributions if the trigger is not hit, lower contributions in the first five years if the trigger is hit, a date certain when the full PUC rate is contributed, and agreement on rapid movement to EAN starting at the end of the transition period."

When asked about this change of opinion during his deposition in connection with the *Gleason* litigation, Mr. Blum replied, "One thing that was very clear after that meeting was that this was a very unclear agreement and what the right interpretation was of that agreement was quite uncertain." Mr. Blum also stated that no one directed him to delete anything from his draft opinion letter of June 12, 2002 so that it would not go into the final version of his opinion. However, SDCERS' Assistant General Counsel Ms. Jacobs communicated to Ms. Chapin in a March 24, 2003 email that she learned from Seltzer Caplan that Mr. Blum had said he wrote his June letter against MP2 because Mr. Grissom told him to "kill the Manager's Proposal". Mr. Grissom then changed his mind and pressured Mr. Blum to "make it happen". In his interview with Navigant Consulting, Mr. Grissom denied giving Mr. Blum these instructions. In the interview he said the only instructions he gave Mr. Blum were to clearly state a position one way or the other. In an interview with Navigant Consulting, Ms. Chapin said that she asked Mr. Grissom about this at the time she received the email and Mr. Grissom told her that the statement was not true.

c. Board Members' Concerns

Board member Diann Shipione was perhaps the most vocal opponent of MP2. She voiced her opinions at Board meetings, stating that she would have never agreed to the proposal nor have voted to provide the City with rate relief. She was opposed to increased benefits being tied to the City's contribution relief. Ms. Shipione also issued letters to the Board and Mayor expressing her discontent with the manager's proposal and her concerns over the Board's operations. In her letter to the Mayor and City Council on November 18, 2002 she stated, "I strongly recommend that you, as representatives of the public trust, do not vote to approve these Ordinances [related to FY 2003 Negotiated Retirement Benefit Enhancements]. However, if you are intent upon doing so, I would suggest that you send this issue to your Ethics Commission before voting on it. I would also strongly recommend that you have outside Legal Council [sic] provided you with an opinion on this issue."

Board member Richard Vortmann also expressed concerns over MP2. He served on the Pension Reform Committee (see Section V.B.3) and expressed concerns regarding the System's funded status. He questioned actuarial methods in a letter to Board President Fred Pierce dated February 18, 2002. He stated: "I get a very strong sense of 'game playing' or anticipatory 'ass covering' by the Actuary. This is most disturbing." After the introduction of MP2, he issued another letter dated June 24, 2002 addressed to all Board members in which he questioned the provisions in and intent behind MP2. He wrote: "Ask the City Manager to come and explain why they put the Board in this position; why it was necessary; and given their 'lessons learned' how do they intend to conduct union negotiations in the future differently to prevent a reoccurrence of this inappropriate situation." He added, "ask the City to explain to the Board a clear statement of why they feel it is necessary to violate their previous '96 agreement." He stated that the improvements in benefits were not the problem but rather "The problem is very simply that the City does not want to pay currently for what they want to give the employees. They clearly are addicted to the 'give now, pay later' or 'burden the future year's taxpayers' when they no longer have any say in the decision – i.e. the decision being locked down now, with the mandatory bill being paid later."

At least one Board member raised concerns about the Board's decision to approve MP2 to Mr. Grissom. After the July 11, 2002 Board meeting, Board member David Crow, who voted against the MP2 motion at the meeting, sent an email to Mr. Grissom on July 12, 2002 that said:

"Yesterdays activities gave rise to the thought that some 'backroom' deals had been made. I also saw some hallway discussions that made me wonder. Several people have commented to me since the meeting about 'conflicts of interest' by several Board members. We know that the conflict will never be called that but it

was obvious that several people were voting with their wallets and were not really fulfilling their fiduciary duties.⁷⁸ A couple were almost laughable in thier (sic) comments. Oh well, it is over and done with and we will all live happily ever after.

I must tell you that I am getting annoyed by a cople [sic] of Board members who while sitting as a trustee are constantly 'pimping' for the City. That is the behavior that annoys the public and makes me think there is a conflict."

Mr. Grissom responded to Mr. Crow on July 15, 2002 as follows:

"Agree with your comments. Seems kind of like a seat on the Board is perceived to provide people with discretion to do stuff that has been pent up in them for al(sic) lot of years."

Mr. Crow then responded on the same day:

"Seems to me that 7 of the 8 City Employees voted themselves a pay raise and benefit improvements last week but none have any concern for the much poorer older retirees, some of whom will truly [sic] suffer without a 13th check. I may be old and suspicious but I am more and more convinced that last weeks meeting was a sham and the decision was a 'done deal' before we had the discussion and the vote."

9. Board Members' Potential Conflicts of Interest

The 2002 MOUs included some unique benefits received by a limited number of employees. Some of the SDCERS' Board members, who also may have participated in the 2002 meet and confer process, received these benefits described below.

At least one Board member, Tom Rhodes, questioned if he could vote on MP2 since he had been involved in union negotiations. In advance of the July 11, 2000 Board meeting, SDCERS' fiduciary counsel and General Counsel concluded it was okay "as long as they are comfortable they can vote as a fiduciary and separate themselves from their role as negotiator."

During the MP2 negotiations, Mr. Blum questioned if Ms. Lexin had a conflict of interest due to her role in the labor negotiations. In an email dated July 30, 2002, Mr. Blum raised a concern to Mr. Grissom, Mr. Barnett and Ms. Chapin that Ms. Lexin "may be in breach of her fiduciary duties if she both negotiates the agreement for the city and then

⁷⁸ In his testimony at the Preliminary Hearing, Mr. Crow testified that Mr. Grissom later proved him wrong in his assumptions.

sits on the retirement board when it considers whether to approve the agreement.” Mr. Blum also stated in the email that “it seems to us that it would not be fair to kathy [sic] or to the board to raise this issue – if it is a problem – after she had negotiated the contract in good faith.” In a subsequent email dated August 21, 2002, Ms. Chapin wrote to Mr. Blum that “In light of the conflict of interest issues raised, the proposal should be sent to Bruce Herring with a brief explanation of the problems with Cathy brokering the deal from the City and then voting as a trustee.” Navigant Consulting did not identify any further information about this topic during its investigation.⁷⁹

10. 90% Cap Provision

As part of the 2002 meet and confer process, new retirement factors were negotiated and agreed upon, resulting in a change to the allowance cap. All City employees who joined the System after June 30, 2002 received the new factors and their annual retirement allowances were capped at 90% of their salary used to determine the retirement benefit. However, the 90% cap did not apply to those that joined the System before July 1, 2002 and continued to receive the old retirement factors or the Corbett factors (i.e., their retirement allowance would be higher under the previous formulas) and those that joined the System before July 1, 2002 and had already earned benefits above the 90% cap through the new factors, which were later capped on December 31, 2002. Additionally, the 90% cap did not apply to general members that:

- Applied to purchase Creditable Service on or before June 5, 2002 and signed the contract to purchase at that time,
- Were hired at age 24 or younger, and
- Exceeded the 90% cap because of the Creditable Service he or she applied to purchase on or before June 5, 2002. The member could not exceed the cap by Creditable Service that he or she applied to purchase after June 5, 2002.

Ms. Webster, was not subject to the 90% cap as she began working for the City before the age of 24. Navigant Consulting understands that this exception potentially applies to approximately 300 other City employees.

11. Presidential Leave

a. The History of the Presidential Leave Benefit

As early as 1989, disparities with presidential benefits existed for union presidents. Since 1989, the POA president was allowed to purchase service credit in SDCERS for

⁷⁹ During his interview with Navigant Consulting, Mr. Grissom did not recall Mr. Blum’s email or any discussion regarding these emails. Navigant Consulting was unable to interview Ms. Chapin regarding these emails.

leave without pay ("LWOP") while serving as union president. In addition, the POA was allowed to pay normal retirement contributions, both employer and employee portions, on behalf of its union president. The MEA president, Judie Italiano, applied to buy back years of creditable service in SDCERS while she was on LWOP serving as union president and the Board granted her request in October 1997. This benefit became applicable only to the Presidents of the MEA and POA. Presidents of Local 127 and Local 145 had different employment arrangements whereby they continued to be paid as full-time City employees while serving as union presidents. Accordingly, they continued to be members of SDCERS earning retirement benefits based on their length of service and City-paid salaries.

b. The Presidential Leave Benefit Included in the 2002 Meet and Confer

The City Council passed a resolution on October 21, 2002 allowing union presidents and former POA union presidents to utilize both their City salary and union salary, not to exceed the current salary of the Labor Relations Manager, in their retirement calculations. This change, among others, arose from the meet and confer negotiations that took place with the unions earlier that year. According to Ms. Italiano, Dan Kelley, who handled the labor negotiations for the MEA, informed her that the Local 145 union president at that time, Mr. Saathoff, requested similar treatment of his union salary as well as his City-paid salary, in the determination of retirement benefits. As a result, the City Council decided that (as outlined in Resolution 297212):

- The high one-year salary for purposes of calculating the retirement benefit formula for incumbent presidents of the MEA, POA, and Local 145 would be based on their respective combined City and union salary, not to exceed the annual base salary of the City's Labor Relations Manager.
- The same provision would apply to former POA presidents who have not yet retired from City service.
- The employer's and employee's share of the retirement contribution for these incumbent union presidents would be based on their respective combined City and union salary.
- Effective July 1, 2002, the employer's and employee's contribution to the System for the union salary and City salary would be paid by those presidents or their respective unions.
- The employer's and employee's share of the retirement contribution for the incumbent president of Local 145 for fiscal year 2002 would be based on his combined union and City salary, but not to exceed a combined salary of \$108,000.

The union presidents of the MEA, POA, and Local 145 at the time who benefited from these new presidential benefits were Judie Italiano, Bill Farrar, and Ron Saathoff, respectively. Additionally, the former POA presidents who were still employed by the City, Harry Eastus and Gary Collins, benefited through the payment of employee contributions by the POA.

In addition to the particular clause for the union president of Local 145, the City Council entered into a separate agreement on October 24, 2003 with Mr. Saathoff, to calculate retirement benefits using his combined union and City salaries retroactively starting July 1, 2001. Navigant Consulting has not identified any documents that indicate that other union presidents received salaries from both the City and the union. As such, this benefit appears only to apply to Mr. Saathoff. His DROP benefits were computed using his combined union and City salaries during those years, which was stipulated in the City Council Resolution 297212 not to exceed the salary of the Labor Relations Manager. The overpayment in benefits was not discovered until 2004, when the City's internal audit department conducted an audit of Mr. Saathoff's presidential benefits.

c. SDCERS' Board and Fiduciary Counsel Knowledge of the
Presidential Leave Benefit

Several of the Board members would have known about Mr. Saathoff's presidential leave benefit in her/his role as a City employee. SDCERS' Staff knew about the benefit.⁸⁰ Mr. Blum, said he was unaware of the benefit. The Board minute summaries and transcripts for the May, June and July Board meetings in 2002 do not discuss the presidential leave benefit.

12. June 30, 2003 Actuarial Valuation Indicated the System's
Deteriorating Funded Status

GRS issued its annual actuarial valuation as of June 30, 2003 dated January 8, 2004. This valuation included the benefit increases for general members that became effective as a result of MP2⁸¹ and reported a decrease in the funded ratio from 77.3% to 67.2%. The valuation also reported contribution rates of 27.94% of payroll, an increase from the

⁸⁰ Chapin email dated September 6, 2002 to Ms. Lexin, Ms. Webster, Mr. Grissom and others stating "The Board has not reviewed the Presidential Leave issue and does not have to..."

⁸¹ The benefit enhancements became effective on July 1, 2002 and were not reflected in the June 30, 2002 actuarial valuation. This is acceptable under actuarial standards but is inconsistent with the approach taken with the benefit enhancements under MP1 and the Corbett settlement. Had the impact of these benefit enhancement been reflected at June 30, 2002, the funded ratio would have been even further below the 82.3% trigger.

contribution rate of 21.13% in the previous valuation. The valuation noted significant contribution shortfalls relative to the computed rates.

Other comments in the valuation noted the following:

- There was a 4.6% positive investment return, but this resulted in a -3.4% actuarial return based on the 8% assumed rate of return. Although there was some turnaround in the investment markets the five-year smoothing of actuarial value of assets will delay the positive impact and past losses have not yet been fully recognized.
- The valuation did not reflect the contingent Corbett benefits which would have added \$70 - \$76 million to the unfunded liability and lower the funded ratio by 2%.
- The valuation noted continued popularity of DROP and continued actuarial losses resulting from purchased service credits.

In the June 30, 2003 actuarial valuation, GRS eliminated the statement made in prior annual valuations that the financial condition of the retirement system is in “adequate condition in accordance with actuarial principles of level-cost financing.” During Navigant Consulting’s interview with Mr. Roeder, he said that GRS removed this statement from all of its public sector clients because of uncertainty about the definition of “actuarial soundness”.

City contributions as compared to the ARC for fiscal years 2002 through 2004 as reported in the draft 2004 CAFR are shown in the table below.

(000s)	2002	2003	2004
Actuarial Required Contribution	\$66,333	\$81,716	\$103,358
Contribution Made	\$49,744	\$70,100	\$81,832
Contribution Shortfall	\$16,589	\$11,616	\$21,525
Percentage of ARC Contributed	75%	86%	79%

The City contributed an additional \$15.5 million on June 30, 2003 on behalf of the City’s Proprietary and Fiduciary Funds for fiscal years 1997 through 2002 due to the difference between the contribution rates calculated by the actuary and the City-paid contribution rate based on MP1.

G. Gleason Litigation

On January 16, 2003, a putative class action complaint was filed against SDCERS and the City by two retired City employees on behalf of a class of City retirees (the “Gleason

litigation”).⁸² The complaint alleged that the SDCERS’ Board breached their fiduciary duties to the members of the class by entering into agreements, namely MP1 and MP2, with the City that allowed the City to contribute funds to SDCERS at less than the actuarially determined contribution rates. The complaint also alleged that certain SDCERS’ Board members violated the California Government Code conflict of interest provisions (Section 1090) by agreeing to MP2 so that they received increased pension benefits.

On March 5, 2003, SDCERS received a letter from its counsel for this litigation, Seltzer Caplan, regarding the initial analysis and recommendations regarding the defense of SDCERS in the Gleason litigation. In this letter, Seltzer Caplan provided SDCERS with a number of preliminary conclusions and recommendations including:

- “The Individual Defendants⁸³ breached their fiduciary duty by adopting the ‘02 Proposal in its modified form because it resulted in a lower contribution obligation by the City, as well as an increase in vested liabilities, without any basis for accepting the City’s contention that it would meet its increased contribution obligations in the final years covered by the ‘02 Proposal.”
- “The Individual Defendants subordinated SDCERS’ interests to the interest of themselves, their unions, and the City.”
- “SDCERS Staff should recommend to the Board that it exercise its right under the November 18, 2002 Agreement to ‘nullify this Agreement to be extent required by its duties established under the California Constitution...’.”

Ultimately, this litigation was settled and approved by the Court on July 26, 2004. Pursuant to the agreement, the City’s fiscal year 2005 contribution totaled \$130 million.⁸⁴ The City’s contribution for fiscal years 2006, 2007 and 2008 will be determined by the SDCERS’ actuary in accordance with provisions set forth in the settlement agreement. The actuarial advisors assisting in Navigant Consulting’s investigation have advised that the methodology described in the settlement agreement should result in an Actuarial Required Contribution (“ARC”) in accordance with GASB rules. The City provided collateral of \$375 million for its contributions for fiscal years 2006-2008.

⁸² *James F. Gleason, et. al. v. San Diego City Employees’ Retirement System, et. al.*, (San Diego Super. Ct.) (No. 803779).

⁸³ Reference to individual Board members

⁸⁴ By letter dated February 22, 2004, the SDCERS’ actuary “approved” of the City’s \$130 million contribution for fiscal year 2005 based on his estimated calculation of \$140 million for that time period.

VIII. Retiree Health Benefits

For many years, SDCERS has played a role in the retiree health care program. In connection with changes to benefits and actuarial methods in 1991, SDCERS was to establish a new trust fund to be funded from surplus earnings to pay for these costs.

The June 30, 1994 actuarial valuation discussed that prior to fiscal year 1994, retiree health insurance premiums were funded from “excess” earnings, if any, above the actuarial interest rate. For fiscal year 1995, the City paid approximately \$5 million to a separate trust and received a credit reducing its pension contribution from the Retirement System for the amount of this payment. This credit was reflected as a portion of the employer contribution (i.e. the actual City contribution was reduced by the health insurance premium).

Again in fiscal year 1996, the System credited the City contributions for approximately \$5 million. Subsequent to fiscal year 1996, the City ceased receiving credits from the System for these insurance premiums because fiduciary counsel opined that contributions for pension benefits should not be reduced for post-retirement medical benefits.

Prior to 1996, it is unclear how SDCERS treated retiree health benefits in its CAFRs because the CAFRs did not contain financial statement captions or disclosures regarding these benefits. However, SDCERS administered the retiree health benefits from as early as 1982 when the City withdrew from the Social Security System.

In connection with the adoption of MP1, the SDCERS’ actuarial valuations reflected a reserve and payments for retiree health benefits. The amounts reflected in the actuarial valuations are shown in the following table.

Fiscal Year	Health Benefits Paid (1)	Health Benefit Reserves (2)	Plan Expense (Change In Reserve Plus Benefits Paid)	Reported Underfunded Employer Contributions (1)	Reported Underfunded Employer Contributions - Adjusted
2004	\$ 12,829,903	\$ 7,910,366	\$ 0	\$ 21,525,469	\$ 21,525,469
2003	11,450,200	20,740,269	1	11,616,292	11,616,293
2002	8,882,138	32,190,468	14,317,074	16,589,464	30,906,538
2001	7,207,618	26,755,532	12,771,253	13,092,698	25,863,951
2000	5,413,222	21,191,897	11,374,262	8,770,661	20,144,923
1999	5,400,264	15,230,857	9,000,000	8,010,645	17,010,645
1998	4,368,879	11,631,121	9,000,000	9,174,265	18,174,265
1997	-	7,000,000	7,000,000	5,420,253	12,420,253
1996	-	-	-	3,634,363	3,634,363
Total	\$ 55,552,224	\$ 142,650,510	\$ 63,462,590	\$ 97,384,110	\$ 161,296,700

Source(s):
(1) SDCERS' Comprehensive Annual Financial Report (CAFR)
(2) Actuarial Valuation Report

Health benefits paid are shown as disbursements in the SDCERS' financial statements. The health benefit reserves represent amounts funded to a 401(h) trust set up to pay retiree health benefits. Excluding the health benefit reserves from the actuarial value of assets effectively increases the UAAL each year. Navigant Consulting was unable to determine whether the City funded these reserves through contributions, or if the reserves were funded from the System's assets (i.e., surplus earnings). However, if the City paid for the retiree health benefits from its annual contributions, then the City's contributions shown on the Schedule of Funding Progress in the SDCERS' CAFR have been overstated.

The annual City contributions on the Funding Progress Schedule equal the total City contributions included in the Comparative Statement of Changes in Net Plan Assets. The cumulative funds deposited in the 401(h) trust were approximately \$63.5 million shown in the above table. Therefore, on June 30, 2003, the City's contribution to SDCERS was overstated by approximately \$63.5 million due to the use of reserves to fund retiree health benefits. The UAAL was increased by the same amount.

In approximately February 2005, the City Council adopted an ordinance to appropriate funds from the City's general fund to pay for retiree health care costs. This ordinance

was adopted in response to a recommendation from the Pension Reform Committee that retiree health costs no longer be funded in a manner that reduces assets of SDCERS.

The costs to administer the retiree health benefits program appear to have been paid with pension assets instead of being separately funded by the City. Administering the program includes processing claims, paying health program premiums, maintaining eligibility records and processing plan enrollment changes. The operations division consists of three staff members with full-time responsibility for administering retiree health benefits, management oversight by the Operations Manager, and the use of temporary staff during peak work periods. The administrative costs are separately tracked within the SDCERS' accounting system. Navigant Consulting recommends that the expense to administer retiree health benefits be quantified and reimbursed by the City.

IX. Actuarial Analysis

A. Analysis of Unfunded Liability

In the latest available actuarial valuation as of June 30, 2004, SDCERS reported an Unfunded Actuarial Accrued Liability ("UAAL") of \$1.37 billion and a funded ratio of 65.8%. The actuarial advisors assisting in this investigation prepared an analysis of the major components of the UAAL which is shown below.

During the period from July 1, 1996 to June 30, 2004 the unfunded liability increased from \$47 million⁸⁵ to \$1.37 billion. The Hay Group performed an analysis using data reported in the Gabriel Roeder Smith annual actuarial valuations to determine the events causing the UAAL. A small portion of the growth in the unfunded liability is the expected increase due to the passage of time. However, most of the increase was attributable to events that had not been anticipated when the actuary performed the June 30, 1996 valuation.

The actuarial advisors who assisted with Navigant Consulting's investigation determined gains and losses that were identifiable were allocated into the following categories with the proportion for each category indicated:

⁸⁵ The \$47 million UAAL at July 1, 1996 is prior to the adoption of MP1 and has been calculated from information provided in the June 30, 1998 actuarial valuation.

Category	
Benefit improvements	39%
Net investment losses	11%
Service purchase costs	9%
MP1 and MP2 contributions lower than the ARC	7%
Increases in assets held outside plan assets, primarily for DROP and COLA	12%
Actuarial assumption changes	7%
Other actuarial gains and losses	<u>15%</u>
Total	100%

Complete information on the sources of gain and loss was not included in the 1998, 1999 and 2000 GRS annual valuations and was not otherwise available. The above analysis includes the portion of the gain and loss that was not identified in those three years in other actuarial gains and losses. This analysis covers a different time period than similar analyses prepared by GRS and Mercer, and accordingly, results in a slightly different breakdown among the components.

As can be seen by this analysis, the single largest factor contributing to the unfunded liability is the benefit improvements granted during this time period, particularly those associated with MP1 and MP2, and the Corbett settlement. The \$1.37 billion unfunded liability does not include the benefit improvements granted to retirees in connection with the Corbett settlement. These additional benefits add approximately \$70 million to the unfunded liability and make the benefit improvements component above to be 42%.

Investment performance only represented 11% of the total decline in funded status. This time period included several years where investment returns were greater than the 8% assumed rate of return, several years with investment losses and years in which there were positive returns but were less than the assumed return of 8%. Consequently, investment returns caused about \$145 million of the total unfunded liability during this seven year period.

The City's contribution shortfalls as a result of MP1 and MP2 contributed approximately \$93 million of the underfunding. The shortfalls totaled \$73 million and the investment return that would have been earned on the shortfalls as of June 30, 2004 was approximately \$20 million.

Actuarial assumption changes relate to actual experience being different from the assumptions initially selected by the actuary. These changes are identified through the experience investigations and included higher salary increases, lower employee turnover and changes in the disability and mortality assumptions and higher attained age of active members. Other actuarial gains and losses include compensation increases greater than expected and employees retiring earlier than expected.

B. Surplus Undistributed Earnings

SDCERS used Surplus Undistributed Earnings to pay for certain benefits over the years. The cost of providing these benefits was frequently not included in the contributions made by the City under the belief that the benefits would be paid for with these earnings. Furthermore, SDCERS and the City operated under the belief that strong investment earnings in the mid 1990s could be used to offset the reduction in contributions for basic retirement benefits in connection with MP1. This could only be the case if the earnings consistently exceeded the assumed rate of return factored into the actuarial valuation. However, if this were the case the actuary would increase the assumed rate which would over time result in a lower ARC. This concept of surplus earnings was written into the San Diego Municipal Code but conflicts with the actuarial methodologies used to determine required contributions, and as described below, is inconsistent with general accounting and economic concepts of accumulating earnings to pay benefits.

Sections 24.1501 and 24.1502 of the San Diego Municipal Code define Investment Earnings Received and Surplus Undistributed Earnings. Investment Earnings Received is determined on a cash basis. Surplus Undistributed Earnings are comprised of Investment Earnings Received less multiple items that have evolved over the years deducted in a prescribed order. This subtraction of items from so-called earnings has been described as the “waterfall.” The items deducted in the “waterfall” include the following as of the April 2, 2002 amendment to Section 24.1502 of the San Diego Municipal Code (not a complete list).

- Interest on contribution accounts;
- Administrative expenses of the system;
- An amount necessary to maintain such reserves as the Board deems appropriate;
- Retiree health benefits;
- Annual supplemental retirement benefits known as the 13th check;
- The Corbett *contingent* benefits to retirees; and
- Interest to the reserves created for supplemental COLA benefits.

The use of cash basis activity for determining Investment Earnings Received and Surplus Undistributed Earnings is inconsistent with the accounting principles used by SDCERS and the actuarial principles used to determine contributions and funded status. This inconsistency, as well as the difference between using actuarial value and fair value of assets, has created problems by distributing surplus earnings that did not actually exist. Furthermore, because certain benefits as well as plan operating costs were deemed to be paid from surplus earnings, there was no direct contribution from the plan sponsor to cover these costs which became more and more significant over time. For

example, in fiscal year 2003, retiree health benefits were approximately \$11.5 million and administrative expenses were approximately \$7.8 million which were not included in City contributions. This was one of the contributing factors to the significant UAAL that developed over time. This concept also added to the complexity and lack of clarity of the SDCERS' financial operations. Navigant Consulting has been informed by its actuarial advisors from the Hay Group that none of its retirement system clients use this concept of surplus earnings.

From an accounting perspective, plan assets are usually classified as cash, receivables, investments and assets for plan operations. For financial reporting purposes, GASB Statement No. 25 requires plan assets (except assets used in plan operations such as office furniture and computers) to be reported at fair value. Fair value is defined as the amount that the plan could reasonably expect to receive for the investment in a current sale between a willing buyer and a willing seller. Generally, fair value is considered market value in an actively traded market. Cash and receivables are short term, and therefore, their carrying value, or historical cost, is generally considered fair value. However, a plan's investments fair value may significantly differ from historical cost, as well as from the actuarial value that is being used for determining the plan's ARC.

Historical cost is the original cost to purchase the investment. Any difference in historical cost compared to market value is commonly referred to as unrealized gains and losses. Under fair value reporting, appreciation (depreciation) in fair value is recognized each period, as the investments are adjusted to reflect their current fair value. Thus, there is no further gain or loss, based on any difference between sales price and original cost, to be recognized upon sale since the gain or loss would be recognized as the fair value changed irrespective of when the investment is sold.

In fair value reporting, the appreciation (depreciation) in an investment's fair value is recognized as an addition (reduction) to plan net assets in each reporting period. However, a realized gain or loss on an investment sold during a reporting period is the difference between the proceeds of the sale and the original cost of the investment. Thus, when an investment that has been held for more than one year is sold, the realized gain (loss) includes amounts that were recognized as unrealized appreciation (depreciation) in prior periods. This situation creates a timing difference between when income is reflected as an increase to the plan assets and when cash is ultimately received when the investments are sold.

A simple illustration of this timing difference is as follows. Assume 100 shares of stock are purchased during fiscal year 1999 at a cost of \$50 per share. The stock's historical cost is \$5,000. At fiscal year end 1999, the stock has appreciated in value to \$60 per share resulting in a fair value of \$6,000. The plan would recognize an unrealized gain as an increase in plan net assets during fiscal year 1999 of \$1,000. During fiscal year 2000, the stock is sold at a price of \$58 per share resulting in total proceeds of \$5,800. Although

the plan realized a net cash gain of \$800 from its investment (sales price less historical cost, or \$5,800 less \$5,000), the plan would recognize a \$200 **loss** for fiscal year 2000.

This timing phenomenon is important to SDCERS because contingent benefits were paid from the System's surplus earnings, which included investment earnings as defined by the Municipal Code⁸⁶, even if the plan had unrealized losses in its investment portfolio for the period. The table below illustrates the differences between the System's net investment earnings on System assets versus realized earnings on System assets.

Fiscal Year	Net Investment Income	Realized Earnings	Difference
2003	\$ 123,111,596	\$ (18,644,596)	\$ (141,756,192)
2002	(75,934,760)	49,082,291	125,017,051
2001	(25,126,082)	164,115,281	189,241,363
2000	349,654,651	417,057,071	67,402,420
1999	180,463,938	187,942,463	7,478,525
1998	278,681,878	246,768,067	(31,913,811)
1997	255,998,283	136,687,652	(119,310,631)
1996	209,227,674	155,077,454	(54,150,220)
Total	<u>\$1,296,077,178</u>	<u>\$1,338,085,683</u>	<u>\$ 42,008,505</u>
Source: 2003 SDCERS' Comprehensive Annual Financial Report (CAFR)			

As illustrated above, over an extended period of time, the total amount of net investment income approximates the total amount of realized earnings. The significance of the table above shows how the net investment income versus realized earnings can impact the annual calculation of surplus earnings. For example, in fiscal year 2001, SDCERS experienced a net investment loss, but had realized earnings as defined by the Municipal Code. These realized earnings were considered to be available to pay for benefits and System costs in the "waterfall" calculation even though the fund experienced an economic loss for the fiscal year. This conflicted with actuarial standards and created dual pressure on the funded status of the System as the true investment

⁸⁶ Investment earnings received are defined as: all interest received (net of interest purchased) on notes, bonds, mortgages, short-term money market instruments, and savings accounts; cash dividends received on stock investments; and all realized gains and losses from the sale, trade, or conversion of any investments of the Retirement System, Municipal Code ch. 2, art. 4, div. 1, § 24.0103.

losses decreased System assets and some System assets were used to pay the cost from the “waterfall” without corresponding contributions from the City.

A further important concept in the determination of surplus earnings is whether the System’s assets generated a return greater than the actuarial assumed rate (generally 8%). The following table illustrates that over an extended period of time, earnings from System assets, calculated utilizing realized earnings or unrealized earnings, approximated the actuarial assumed rate of return.

Fiscal Year	Annual Total Return	Annual Realized Rate of Return
2003	5.44%	-0.96%
2002	-2.40%	2.02%
2001	-0.75%	6.26%
2000	15.18%	18.24%
1999	9.59%	9.70%
1998	14.64%	14.33%
1997	16.88%	9.57%
1996	15.08%	11.96%
Average	9.21%	8.89%
Source: 2003 SDCERS’ Comprehensive Annual Financial Report (CAFR)		

The realized earnings of any given year may exceed the actuarial assumed rate of return; however, this excess is not a real surplus. In the bear market of the 1990’s, the System earned a high rate of return, resulting in the false belief that contingent benefits, contribution shortfalls and new benefits could be funded through investment earnings.

C. Actuarial Standards - Standards of Practice for Pension Plan Actuaries in the United States

Actuaries in the United States belong to one or more of five professional organizations. These are:

- The American Academy of Actuaries (Academy)
- The American Society of Pension Professionals and Actuaries (ASPPA)

- The Casualty Actuarial Society (CAS)
- The Conference of Consulting Actuaries (CCA)
- The Society of Actuaries (SOA)

Most large public employer pension plans require that the primary actuary be a Fellow of the Society of Actuaries or the Conference of Consulting Actuaries. Private sector plan actuaries also need to be Enrolled Actuaries under ERISA (as approved by the federal Joint Board for Enrollment of Actuaries) and public employer plans often require this designation as well.

The professional actuarial organizations in the United States have adopted the professional standards promulgated by the Actuarial Standards Board (“ASB”) with cases decided by the Actuarial Board for Counseling and Discipline (“ABCD”). The activities of the ASB and ABCD are coordinated by the Academy. The following describes and quotes sections of the standards pertinent to this report. The full text of the Standards (as well as the Code) can be accessed by clicking on “standards” at the Academy’s web site (www.actuary.org).

The ASB Code of Professional Conduct sets forth the general requirements for actuaries and a set of Actuarial Standards of Practice (“ASOP”) which guide the actuary in specific types of work. The ASB has promulgated this Code of Professional Conduct as a statement of “...the high standards of conduct, practice, and qualifications of the actuarial profession...”.

Precept 1 states that “An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession.” Annotation 1-1 to Precept 1 states that “An Actuary shall perform Actuarial Services with skill and care.”

Precept 3 states that “An Actuary shall ensure that Actuarial Services performed by or under the direction of the Actuary satisfy applicable standards of practice.”

Precept 4 states that “An Actuary who issues an Actuarial Communication shall take appropriate steps to ensure that the Actuarial Communication is clear and appropriate to the circumstances and its intended audience and satisfies applicable standards of practice.”

ASOPs provide specific detailed guidance on how to perform specific actuarial duties. The most pertinent standard for pension valuations is ASOP No. 4--Measuring Pension Obligations. It indicates that all aspects of a pension plan should be considered to assure that all significant liabilities are reflected in an actuary’s valuation results. Specifically, Section 5.2.2 states the following:

“Plan Provisions—All provisions of the plan adopted and effective on or before the start of the plan year should generally be taken into account in measuring pension obligations, as should administrative practices with respect to matters not directly addressed in the plan.”

ASOP No. 23 addresses Data Quality. ASOP No. 23 places the burden on the actuary to determine that the data are correct and complete, even when, as is usually the case, data are provided by another party.

ASOP No. 41 addresses Actuarial Communications. This standard specifies (in Section 3.1.2) that “The actuary should take appropriate steps to ensure that the form and content of the actuarial communication are clear and appropriate to the particular circumstance, taking into account the intended audience.” The standard also specifies (in Section 3.1.3) that “The actuary should issue an actuarial communication within a reasonable period following completion of the actuarial analysis...”.

D. Actuarial Soundness

The actuarial report delivered to the Board shall serve “as a formal means of conveying the actuary’s findings, (which include) the results of the actuary’s work, i.e., the actuary’s professional conclusions, recommendations, or opinions”.

Though it does not appear that the Board has ever developed a clear definition of actuarial soundness in its funding policy, an example of such a definition (from a comparable public pension review board) is as follows:

“The financial objective of the pension plan shall be to establish and receive contributions which will remain approximately level from year to year and will not have to be increased for future generations of citizens. This objective is achieved when contributions received each year by the pension fund are sufficient both, (1) to fully cover the costs of benefit commitments being made to employees for their service being rendered in such year and, (2) to make a level payment which, if paid annually over a reasonable period of future years, will fully cover the unfunded costs of benefit commitments for service previously rendered.”

In March, 2005, the League of California Cities’ Board of Directors adopted recommendations reported by the League Pension Reform Task Force, indicating that pension benefit levels “be supported with proper actuarial work to justify pension levels...The Legislature should reject any and all attempts to establish pension benefits that bear no relation to proper actuarial assumptions and work.”

As an additional example, the March, 2005 issue of the Public Sector Letter published by The Segal Company reports that “although actuarial balance is likely to require a longer-term horizon, when it is achieved there will be interest, especially by plan participants, in enhancing benefits. Given the volatility in securities markets, caution should be the key approach to any benefit enhancement...plan sponsors should look beyond the valuation when examining the increases in benefits...The plan sponsor will also want to set policies around how and when to improve benefits...Achieving a balance between benefit security and funding stability is a delicate task. It requires ongoing ‘financial engineering’---diligence in monitoring a plan’s fiscal health and making course corrections in a timely and planned manner.”

The actuary should furnish the Board with all of the tools to make a determination of actuarial soundness, in accordance with its published funding policies.

E. Observations Regarding Actuarial Work

1. Annual Actuarial Valuations

Pursuant to the Board Rules, the SDCERS’ Board retains the services of an outside actuary to perform the annual actuarial valuation. As part of this process, the actuary calculates the contribution rates and the System’s assets and liabilities. On an annual basis, the actuary recommends assumptions and methodologies subject to Board approval. During the time period of Navigant Consulting’s investigation, Buck Consultants and GRS served as the System’s actuary. GRS became the System’s actuary beginning in 1992. The Board hired Cheiron, Inc. to be the System’s actuary effective for the June 30, 2005 actuarial valuation. This valuation has not been completed as of the date of this report and was not considered in the scope of this investigation.

The valuation reports did not make it clear that the City was underfunding the System. In each valuation issued by Gabriel Roeder Smith from 1992 to 2004 there were statements about the Funding Objective which said:

“The funding objective of the Retirement System is to establish and receive contributions, expressed as percents of active member payroll, which will remain approximately level from year to year and will not have to be increased for future generations of citizens.”

There were additional statements in each valuation report that said the following:

“The principle of level percent payroll financing intends that this year’s taxpayers contribute the money to cover IOUs being handed out this year. By following this principle, the employer contribution rate will remain approximately level from generation to generation – our children and

grandchildren will contribute the same percents of active payroll we contribute now.”

These general statements are inconsistent with the actual funding that was occurring. In most of the valuation reports it was not clear that the City was not paying the rates determined by the actuarial calculations.

Several of the annual actuarial valuations prepared by GRS noted that the City funding method is not one of the six approved funding methods set by GASB. The 1997 valuation report had the same statement but also stated that the actuary will attempt to see if GASB will approve the City’s funding method. In his interview with Navigant Consulting, Mr. Roeder said that he drafted a letter to GASB making this request, but never sent it. The actuarial advisors to Navigant Consulting’s investigation believe that if such a request was made it would not have been approved by GASB because the funding method did not cover normal cost plus amortization.

2. GASB 25 Disclosure Requirements

GASB 25 requires, in part, that the retirement system report a schedule of employer contributions that presents the Actuarial Required Contribution (“ARC”) and the percentage of the ARC that was paid for each of the past six fiscal years.

The actuary included the GASB 25 comparison in the 1996 actuarial report which was the first year requiring this disclosure. The table presented showed the six years ending June 30, 1991 to June 30, 1996 and showed that the ARC and employer contributions were equal. The actuary did not include this comparison in any years after 1996. The contributions for the year ending June 30, 1997 and later fiscal years would have been lower than the ARC due to MP1.

3. Periodic Reporting to SDCERS’ Board

The scope of the actuary’s responsibilities should be agreed upon in advance and documented in the written terms of the engagement agreement between the Board and the actuary. The preparation of the actuarial valuation on an annual basis, may be designed to present the core end-product of those requirements, but may not satisfy all of the responsibilities of the actuary. More specifically, furnishing the Board with an actuarial valuation on an annual basis does not absolve the actuary from disclosing additional information to the Board that may not customarily appear in an actuarial report. ASOP No. 41 defines the actuarial report to be the following:

“a formal means of conveying the actuary’s findings (Section 2.3)...(and requires that) the actuary should take appropriate steps to ensure that the form and content of the actuarial communication are clear and appropriate to the

particular circumstances, taking into account the intended audience (Section 3.1.2). When methods or assumptions are prescribed by law, regulation, or another profession's requirements, the actuary should disclose that his or her work has been performed in compliance with such requirements (Section 3.1.9). Actuarial findings that the actuary considers to be significant should be in written or electronic form (Section 3.3.2)."

ASOP No. 4 specifically recognizes the possibility that external factors may also need to be considered: "The adequacy and desirability of an otherwise acceptable actuarial cost method should be examined by the actuary within the context not only of its parameters and consequences but also of whatever knowledge the actuary has of other matters...that help determine the cost allocation or funding decision (Section 5.2.5.f)." Therefore, the actuary has an obligation to recognize and report all findings and make specific comment as to their effect on the Plan. If the Board does not heed the advice offered by the actuary, the standard requires specific disclosure, at the very least.

The entire issue of the September 2005 Gabriel, Roeder, Smith & Company Insight Newsletter focused its attention on training a Board to achieve good pension governance. It discusses the need to devote more effort to identify, understand, and manage risk through effective trustee education and the ability for the trustees to shift from a "hands-on" operational perspective to a "policy and oversight" perspective. Though the responsibility of making this happen can not fall solely on the shoulders of the actuary, it is customary for the actuary to consult in that arena and foster good pension governance.

4. Experience Investigations

As previously discussed, the Board engages its actuary to perform experience investigations on a periodic basis. The purpose of these investigations is to assess the appropriateness of the assumptions being used based on actual experience. Experience investigations were performed by Gabriel Roeder Smith covering the periods from July 1, 1997 to June 30, 2001 and July 1, 2001 to June 30, 2004. The Hay Group advised Navigant Consulting that this is a common practice for the public sector pension plans.

It appears that most items identified were addressed and factored into subsequent valuations, but did not have an impact on City funding which was not determined from the actuarial valuations.

The more notable matters covering the period July 1, 1997 to June 30, 2001, dated January 9, 2003, raised in the experience investigation are as follows:

- The study noted “markedly lower withdrawal rates than anticipated, particularly after age 40” and recommended another reduction. It does not appear that this recommendation was implemented until the June 30, 2004 valuation.
- GRS stated a “slight preference” to reduce the 8% assumed rate of investment earnings given that the Corbett contingent benefits were being paid from investment earnings. They also noted that more benefits were being funded through excess earnings than four years ago.

GRS completed the experience investigation, covering the period July 1, 2001 to June 30, 2004, in May 2005. As a result, it has not been incorporated into an annual actuarial valuation. The notable findings of this investigation included the following:

- Members are retiring and entering DROP earlier than expected. Actual retirements were more than double what was expected during the 2001 to 2004 period.
- Recommended reducing investment return assumption from 8% to 7.75%.
- Comments regarding payment and recognition of contingent benefits from surplus earnings.
- Recommendation to reflect contingent Corbett benefits in the June 30, 2005 valuation.
- Suggesting including a provision for administrative expenses to the computed contribution rates.
- Recommended returning to Entry Age Normal funding method using a 15-year amortization period after the funding terms of the Gleason settlement.

5. Actuarial Audits

Pursuant to the Board Rules, the SDCERS’ Board engaged two different actuarial firms to conduct audits of the SDCERS’ actuary. An actuarial audit appears to be a common practice among pension plans as described in the August 2003 issue of Gabriel, Roeder, Smith & Company’s Special Report on “The Role of Actuarial Audits in Performing Due Diligence”, the Government Finance Officers Association recommends actuarial audits at least once every 10 years. This includes a critique of the plan actuary’s judgment concerning the plan’s exposure to risk. The results of the actuarial audits are described in detail below.

a. Milliman & Robertson Actuarial Audit

Milliman & Robertson (“M&R”) performed an actuarial audit in 1999 of the Gabriel Roeder Smith June 30, 1998 actuarial valuation and experience investigation for the four year period ended June 30, 1997.

M&R described the scope of its actuarial audit to include the following:

1. "An assessment of the accuracy of the mathematical calculations,
2. A review of the appropriateness of certain recommendations, such as relevant assumptions and methods, contribution rates, and
3. Recommendations for ways to improve the actuarial process and reporting of the findings."

M&R Statement of Key Findings concluded that they "found no financially significant actuarial issues to report."

M&R categorized its findings into three levels of significance to the overall funding status with the most significant being those "areas where changes are needed which will result in a financial impact on the actuarial findings." There were several findings in this category including concerns about census data validity and the recently implemented DROP program. M&R also noted that "the City's current funding policy does not directly correspond to the actuarially determined rate, as implied by Article 24.0801 of the Municipal Code." M&R described two funding approaches used by most retirement systems observing that SDCERS followed a hybrid of these two standard approaches. The report noted that "While the history of the system is to use... an actuarially determined contribution rate, since the adoption of the Manager's Proposal, the actual contributions made to the System... are fixed but increasing over time, at least until 2008." M&R went on to state that it:

"...found no potential financial impact in the computation of the actuarially computed rates; but to the extent the current funding policy is not contributing on an actuarially computed basis, gains or losses will occur. In addition, disclosures required under the new GASB reporting rules will measure and require disclosure of these differences."

The funded ratio reported in the June 30, 1998 actuarial valuation included in the scope of this audit was 94% because the system had not only experienced two years of reduced contributions from MP1, but also strong investment performance. This funded ratio may have influenced the level of emphasis M&R gave to the funding policy.

M&R advised that "Full discussion of these issues from time-to-time can help Board members more effectively carry out their responsibilities."

b. Mercer Actuarial Audit

Mercer performed a similar actuarial audit in 2004 on the Gabriel Roeder Smith June 30, 2003 actuarial valuation and experience investigation for the four year period ending June 30, 2001. In its Executive Summary Mercer stated:

“The purpose of an actuarial audit are [sic] to have an independent actuary review the work of the System’s retained actuary to ensure that it was performed and reported in conformance with applicable actuarial standards of practice, to confirm that the calculations were accurate , and to identify any changes in assumptions, methods or communications that, in our opinion, would improve the quality of the actuarial valuation and the understanding of its intended audience.”

Mercer’s conclusion further stated, “We conclude that the methods and assumptions used by Gabriel Roeder Smith are reasonable and conform to accepted actuarial practice.”

Unfortunately, Mercer did not address the fact that the actuarial methods and assumptions Gabriel Roeder Smith used were ignored for purposes of establishing contributions to the System stating, “Our evaluation examined the actuarial assumptions recommended by Gabriel Roeder Smith in their most recent reports and not those assumptions specified by the Manager’s Proposal.” Mercer seemed to mistakenly believe that there was an actuarial basis for establishing the rates to be paid by the City rather than a negotiated rate with no basis in actuarial science. Mercer pointed out concerns about the contribution levels in its Executive Summary noting that it was not a ‘best practice.’

“Currently the City contributions and the valuation assumptions used to determine the funded status of the System are based on the Manager’s Proposal II. The actuarial assumptions used under the Manager’s Proposal are more aggressive than the best estimates recommended by Gabriel Roeder Smith. This means that there is a higher risk that the System may experience negative actuarial experience in the future, which may lead to increases in actuarial liabilities and increased contribution rates. It also creates a current picture of the funded status of the system that may be overly optimistic unless the System experiences substantial investment and other actuarial experience gains in the future. We believe it is a best practice to use the actuary’s best estimate of actuarial assumptions in order to present the most accurate picture of the System’s financial status to stakeholders.

The Manager’s Proposal also sets the City contribution rates below the actuarial calculated rates. The effect of this increases the unfunded actuarial accrued liability and future contribution requirements unless there are significant gains to offset this loss. The full funding of actuarially determined contributions is considered a best practice because it creates a more stable level funding environment and avoids pushing contributions onto future generations.”

Mercer also commented on the unfunded liability. “We evaluated the causes of the current unfunded liability. Several factors contributed to the underfunding. The most significant contributing factor is investment returns over the past three years. However, the underfunding was also increased by changes in benefit levels, a shortfall in required contributions, and the use of reserves for purposes of providing contingent benefits not subject to the actuarial valuation.”

X. Accounting Analysis

SDCERS’ Staff prepares a CAFR for each fiscal year. In addition to an introduction about SDCERS and sections on investments, actuarial information and statistics about the System, the CAFR contains audited financial statements and notes to the financial statements. The City performs the financial reporting function, including preparation of the financial statements for SDCERS. Before fiscal year 2004, the City’s outside auditor⁸⁷ performed the annual audit. Beginning with the 2004 financial statements, SDCERS engaged an outside auditor independent from the City’s outside auditor. Navigant Consulting did not perform a financial statement audit of SDCERS; however, Navigant Consulting considered SDCERS’ financial statements and the disclosures in the CAFR in connection with its work as discussed below.

A. Authoritative Accounting Literature

SDCERS’ financial statements are prepared in accordance with generally accepted accounting principles promulgated by the Governmental Accounting Standards Board (“GASB”). The GASB issues authoritative guidance related to the accounting, financial reporting, and disclosures for SDCERS.

The most applicable GASB guidance to SDCERS is GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 26, *Financial Reporting for Post employment Healthcare Plans Administered by Defined Benefit Pension Plans*. The GASB required implementation of these statements in the SDCERS’ CAFR starting with fiscal year 1996. The City is required to follow the guidance in GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. Navigant Consulting’s investigation did not include the City’s disclosures in its CAFR or bond disclosures.

GASB Statement No. 25 establishes financial reporting requirements and standards for SDCERS. Under this pronouncement, the standalone financial statements of a public retirement system must have two financial statements and two supplementary schedules. The required financial statements are:

⁸⁷ Caporicci & Larson and previously Calderon, Jaham & Osborne

- (a) a *statement of plan net assets* that provides information about the fair value and composition of plan assets, plan liabilities, and plan net assets, and
- (b) a *statement of changes in plan net assets* that provides information about the year-to-year changes in plan net assets.

The required schedules, which should reflect a minimum of six years, are:

- (a) a *schedule of funding progress* that reports the actuarial value of assets, the actuarial accrued liability, and the relationship between the two over time, and
- (b) a *schedule of employer contributions* that provides information about the annual required contributions of the employer(s) (ARC) and the percentage of the ARC recognized by the plan as contributed.

The notes to the financial statements should include a brief plan description, a summary of significant accounting policies, and information about contributions, legally required reserves, and investment concentrations.

GASB Statement No. 25 and No. 27 provide for a consistent measurement of related information about defined benefit pension plans, including the employer's ARC and the plan's funded status, in financial reporting by plans and their sponsors. These measurements are based on the use of an actuarially sound funding methodology. GASB Statements No. 25 and No. 27 establish a set of *parameters*, or criteria, that a plan's funding methodology is required to meet in order for the information produced by the methodology to be acceptable for financial reporting purposes. If a plan's funding methodology falls within those parameters, the information produced by the funding methodology is required to be used for financial reporting as well as for funding. If it is not used for funding purposes, disclosure should be made in the retirement plan's CAFR that an amount less than the ARC is being funded.

The basic parameters established by GASB are:

- (a) the actuarial valuation should occur yearly (unless the plan calls for a biannual valuation);
- (b) The actuarial valuation should include all pension benefits covered by the plan terms at the valuation date;
- (c) The actuarial assumptions selected should be in conformance with the standards established by the Actuarial Standards Board of the American Academy of Actuaries, Actuarial Standard of Practice No. 4, *Measuring Pension Obligations*;
- (d) The actuarial cost method utilized should be one of the six methods contained in Statement No. 25, paragraph 36d⁸⁸;

⁸⁸ The actuarial cost methods are limited to entry age, frozen entry age, attained age, frozen attained age, projected unit credit, or the aggregate actuarial cost method.

- (e) The actuarial valuation of assets and the investment return assumption should be based upon the market values of the plan assets and long-term investment experience; and
- (f) The ARC should include the normal cost and a provision for amortizing the UAAL.

GASB requires that if the funding methodology did not meet the parameters, then the actuarial assumptions should be modified to calculate the ARC in accordance with the parameters for financial statement reporting purposes. Any differences between the ARC and the funding methodology would result in an accounting event on the plan sponsor's financial statements, typically recognizing a net pension obligation ("NPO"). A plan's financial statements would reflect the difference in the ARC and the funding methodology as an adjustment to the UAAL, and disclose the funding shortfall in the funding progress supplementary schedule noted above.

GASB requires the plan and sponsor financial statements to report the ARC within the parameters, there is no authoritative guidance in determining the funding methodology. The funding methodology may be determined by several factors including municipal codes, state law, or other statutory or legal requirements. The GASB places the reporting and disclosure requirement of funding shortfalls to the plan sponsor financial statements, and disclosures in the plan's financial statements. The GASB places a significant responsibility for calculating the ARC with the plan actuary.

B. SDCERS' Financial Reporting

1. Actual Contributions Versus Required Contributions

Beginning in fiscal year 1996, the City contributed less than the ARC calculated by the SDCERS' actuary. However, the SDCERS' CAFR did not disclose the funding shortfall as required by GASB No. 25 until the fiscal year 1999 financial statements. Beginning in fiscal year 1999, the CAFR included a disclosure about the use of a reserve account to supplement the City's contribution in order to match the contribution recommended by the actuary, but did not disclose the amount of the City's underfunding. Beginning in fiscal year 2001, the SDCERS' CAFR met the GASB No. 25 requirements by including a table that presented the ARC, actual City contributions, the difference between the two and the percentage of the ARC actually paid.⁸⁹

The SDCERS' CAFRs for the fiscal years 1999 through 2003 included a statement that the City's contribution funding method is not one of the six recognized actuarial cost methods. In the CAFRs from 1999 through 2002, there was also a statement that a net

⁸⁹ The Assistant Chief Investment Officer, who was assigned responsibility for preparing the CAFR, included the table based on guidance in the GFOA checklist.

pension obligation has been established in a reserve to supplement the City's employer contributions. Mr. Grissom stated in his interview that this was due to a misinterpretation of GASB No. 25 as an NPO should only be recorded by the plan sponsor.

2. Reporting Retiree Health Benefits

As of fiscal year 2003, SDCERS was not in compliance with GASB Statement No. 26, *Financial Reporting for Post-employment Healthcare Plans Administered by Defined Benefit Pension Plans*. This statement was effective for SDCERS beginning in fiscal year 1997. GASB No. 26 established financial reporting standards for post-employment benefits administered by state and local defined benefit plans. This Statement requires defined benefit pension plans that administer post-employment healthcare plans to present (i) a *statement of post-employment healthcare plan net assets*, (ii) a *statement of changes in post-employment healthcare plan net assets*, and (iii) notes to the financial statements, all in accordance with the pension plan reporting standards. SDCERS included the required statements in its draft 2004 CAFR.

The GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pension*, which SDCERS will need to adopt in fiscal year 2008.

This pronouncement will (i) require accrual and recognition of other post-employment benefits (including post-employment healthcare), cost over a period that approximates the employees' years of service, and (ii) provide information about actuarial accrued liabilities associated with other post-employment benefits and to what extent progress is being made in funding the plan.

3. Forward Looking Disclosures or Comments in CAFR

GASB requires a Management Discussion and Analysis ("MD&A") in the CAFR. SDCERS complies with this requirement, but CAFR lacks clear disclosure of the underfunding of City contributions, declining financial position and no forward looking statements about addressing the declining position.

No disclosure has been made about the reliance on surplus earnings for certain benefits and costs (e.g., 13th check, retiree health, and administrative expenses). The draft of 2004 CAFR shows that the plan does not receive any separate funding for retiree health.

The SDCERS' CAFRs include statements describing the System's funding objective. For example, the June 30, 2003 CAFR states:

“SDCERS funding objective is to meet long-term benefit obligations by maintaining a well-funded plan, which is accomplished by earning consistent long-term investment returns to minimize plan sponsor (employer) and member (employee) contributions.”

The MD&A and Notes to the Financial Statements contain similar statements. These statements are inconsistent and potentially misleading since the City’s actual contributions for fiscal years 1996 through 2002 were not based on the contribution rate calculated by the SDCERS’ actuary. Starting with the 2003 CAFR, SDCERS added disclosures that provide some visibility into the funding arrangement, but continue to lack all of the necessary disclosures about SDCERS’ funding.

XI. Recommendations

A. Corporate Governance Recommendations

As part of its investigation, Navigant Consulting had the opportunity to gain an understanding of certain governance activities which may require specific attention by the SDCERS’ Board. Navigant Consulting also noted areas where governance processes might be strengthened to achieve a "best practices" level of design. Navigant Consulting’s recommendations relative to governance should be considered with two cautions: (i) the Board may have already taken action subsequent to the time periods investigated by Navigant Consulting; and (ii) when it comes to recommendations on governance, there are many workable models and approaches that provide alternatives for the Board to consider.

Navigant Consulting’s governance recommendations are presented in the following broad areas:

- Responsibilities and duties of the Board
- Skills and characteristics of effective Board members
- Board decision-making
- Other matters

1. Responsibilities and Duties of the Board

Fiduciary responsibility: Every Board has the responsibility to understand to whom it has a fiduciary responsibility and to establish a charter which defines the areas where it will act as a Board or through committees of the Board. Boards which are fiduciaries for pension trusts can reference specific laws and regulations at the Federal, state, and local levels, if appropriate, to understand standards and requirements that may apply to the Boards and their individual Board members. Legal standards and requirements applicable to SDCERS are addressed in detail elsewhere in this report. The SDCERS’

Board has adopted Rules of the Retirement Board of Administration as a resource for the Board and its members. The Trustee Handbook also describes responsibilities of Board members.

SDCERS has a specific Board composition which, by its very nature, imposes a unique challenge to the fiduciary requirements of SDCERS' Board members. Effective April 1, 2005, following the passage of Proposition H, Board membership is comprised of one City Manager designee; two elected general members; three elected members, one each from Police, Fire and a retiree; and, seven citizens appointed by the Mayor and confirmed by the City Council. The very composition of the Board presents opportunities for conflict with standards of fiduciary responsibility and the sole responsibility of the SDCERS' Board to participants in the SDCERS.

Due to the sheer volume and complexities of Federal, state, and local laws and regulations relating to the duties and responsibilities of pension Board members, and considering the composition of the Board, Navigant Consulting recommends that the Rules of the Board of Administration and the Trustee Handbook be reviewed and updated annually, and in the interim if necessary, by legal counsel representing the Board. It is also important for the Board to understand when Board members should recuse themselves from matters where a Board member's constituency or the Board member individually, might be affected by actions of the Board. Legal counsel should assist in the determination of conflicts of this nature and the protocol that the Board should use to resolve them.

Setting the "Tone at the Top": Much has been written about "tone at the top", the ethical standards that Boards and chief executives set, and its importance cannot be underestimated. Organizational behavior often times mirrors the standards of integrity and fair dealing (i.e., avoidance of conflicts of interest, self entitlements, etc.) exhibited by Board members and high ranking executives. Both the Rules of the Board of Administration and the Trustee Handbook discuss conflicts of interest in a legalistic manner. Navigant Consulting recommends that the Board adopt a "common English" statement of ethical standards and communicate it to the organization frequently. Whether a part of the statement of ethical standards or communicated separately to the SDCERS organization, it is critical that the Board develop a culture of autonomy, both in fact and in appearance, within the executives and staff of SDCERS as it relates to the City.

Oversight: Boards and committees of Boards typically share their expertise, oversee and approve critical strategic and operational actions of the entity that they serve. It is common, and, with respect to certain functions, required for Boards of publicly traded companies, to establish standing committees to address governance, compensation of the Administrator and compensation plans for all Executive Staff, financial reporting and the internal and external audit, investments and other such activities as strategic

planning, if significant. In the case of SDCERS, the Rules of the Board of Administration specify the committee structure that will be used (Navigant Consulting understands that the use of standing committees of the Board has been suspended). Navigant Consulting recommends that the SDCERS' Board committee structure be re-evaluated at this time. Standing Board committees, comprised of Board members with appropriate training and expertise, should oversee the critical activities of SDCERS:

- strategic planning,
- funding of the pension plan by the City of San Diego to ensure that funding is based on sound actuarial principles,
- investment of pension funds,
- distribution of pension funds in accordance with contractual agreements,
- assessment of the performance of the SDCERS' Administrator and determination and approval of executive compensation,
- assessment of the performance of other functions and Executive Staff, and
- financial reporting, internal controls, and the external audit.

Self - assessment: Many Boards have adopted a best practice of assessing the effectiveness of the Board. This is typically accomplished through a standing committee entitled, the Governance Committee. Navigant Consulting recommends the use of a Governance Committee to conduct an annual self - assessment of Board members, an assessment of Board effectiveness by Board members, and assignment of Board members to the other standing committees. The Governance Committee should also oversee orientation of new Board members and assess the need for specific skill training for Board members. The Board should also conduct discussions with departing Board members to understand their perspectives on the effectiveness of the Board.

Reporting relationships: Boards generally receive information from multiple sources both within and outside the entities on whose Boards they serve. Internal sources often include Executive Staff and managers of critical functions within the entity. The benefit of receiving information directly from several management sources is that it allows Board members to assess the competency of management in a more direct way and it reduces the likelihood that information is "filtered" through the Administrator. While it would not be the norm that the organization chart would show the reporting relationship of management functions (other than internal audit) directly to the Board, Navigant Consulting recommends that the SDCERS' Board establish the protocol whereby the Board, or its standing committees, receive direct reports from the SDCERS' Executive Staff. The Board should also make it clear to all Executive Staff of SDCERS that they have an open invitation and a responsibility to bring any concerns that they might have to the Board.

2. Skills and Characteristics of Effective Board Members

Business and technical expertise: Board members are typically chosen for their capabilities, whether from general experience or based upon a technical skill relevant to a business. Board members on the SDCERS' Board are elected or appointed based on Proposition H mandate and come from diverse backgrounds. They may or may not have specific experience or skills that, unless specialized training is made available to them, will make it difficult for them to perform effectively as Board members. Navigant Consulting recommends that the SDCERS' Board engage an expert to perform a review of the Board orientation process for all new Board members to ensure that effective orientation and general training is provided to all new Board members.

Additional training may be appropriate for current Board members so that they can deal with the complexity of the issues. In order to address this need, Navigant Consulting also recommends that the SDCERS' Board engage a consultant with expertise in training programs to develop a training curriculum for all Board members with respect to general Board member skills and those specialized skills that will be called for depending on assignments to committees of the Board.

Characteristics of Board members: In order for a Board to function effectively, Board members must have certain attributes, including those that respect diverse viewpoints and promote a constructive environment in which issues can be discussed and resolved. Navigant Consulting recommends that the Board assess its need for a facilitator to evaluate the effectiveness of the Board in its working relationships within the Board and as it relates to others externally.

3. Board Decision – Making

Decision - making process and documentation: A critical responsibility of any Board relates to issues: how issues are raised, discussed, analyzed, and resolved. The SDCERS' Board's process for issues management and resolution should ensure that the identification, discussion, analysis, and resolution of issues are accomplished in a manner that is transparent and clearly documented. Consider providing Board members with comprehensive issue analyses or "white papers". Both the discussion and resolution of issues should be documented in minutes of the Board. Board minutes and supporting documentation should be viewed as the primary source to provide rationale for decisions and should demonstrate that the Board has fulfilled its duties when addressing and resolving issues before it. Legal counsel should assist the Board in determining how and when the Board has fulfilled its duties under existing laws and regulations.

Use of advisors: While the ultimate responsibility for the process used to make decisions, and the decisions themselves, rests with the Board, it is important for Boards to obtain the counsel of experts when dealing with complex issues. The Board should satisfy itself with respect to the objectivity and independence of expert advisors that it hires and be satisfied that the expert advisor has a proper basis for his conclusions. This can involve careful study of experts' analyses and thorough discussion and questioning of experts' conclusions. Good judgment and legal counsel should be used to assess the need for outside experts and when the Board has fulfilled its responsibilities in relying on the work of experts.

4. Other Matters

Document retention policy: Due to its importance in the current environment, the Board should ensure that a document retention policy is in place and reviewed periodically. Typically, the Board will delegate the authority to review and amend the policy to the compliance officer and / or general counsel working with outside counsel with expertise in this area. The final policy would then be presented to the Board for its review and approval.

Compliance officer role: Due to the significance of ramifications that may arise when internal policies and procedures are not followed, many companies have designated a compliance officer. Because incidents of noncompliance frequently have legal aspects, the compliance officer role is often assigned to the General Counsel. The Board should consider designating a member of the Executive Staff, perhaps the General Counsel, to assess and report to the Board relative to compliance with critical policies and procedures of SDCERS.

B. Other Recommendations

Based on its findings and observations during the investigation, Navigant Consulting recommends that the Board consider the items that follow. Since Navigant Consulting investigated historical events, it may be possible that the Board has already addressed some of these items.

1. Consider Developing a Definition of Actuarial Soundness

During the investigation period, the SDCERS' Board did not have a definition of "actuarial soundness". Navigant Consulting understands that there are various ways to assess "actuarial soundness" and that this is a subjective determination. As a result, the Board may consider working with SDCERS' new actuary to determine a reasonable definition of "actuarial soundness" and an approach for periodic assessment of actuarial soundness to apply to SDCERS.

2. Consider SDCERS' Treatment of Disability Benefit Payments in Connection with the Corbett Settlement

Navigant Consulting learned during some of its interviews that SDCERS calculates disability benefits using the factors outlined in the Corbett settlement although the settlement agreement and the related provisions adopted in the Municipal Code do not include these members. Navigant Consulting understands that the prior Administrator may have decided to include these members. Navigant Consulting does not know if Mr. Grissom consulted with others to make this decision. The Board may wish to conduct further investigation to determine (i) whether disability benefits payments should be impacted by the Corbett settlement, (ii) whether the current practice should be altered or if the Municipal Code needs to be amended to include disability benefits (iii) if any benefits have been overpaid and whether they need to be recovered, and (iv) what additional actions, if any, SDCERS should take.

3. SDCERS' Executive Staff

The Board delegated the responsibility for supervising the SDCERS' Staff to the Administrator. In connection with hiring a new Administrator, the Board may consider assuming a greater level of involvement with the SDCERS' Staff.

Navigant Consulting observed that SDCERS' Executive Staff, excluding Mr. Grissom, consisted of former City employees. As a result of their prior affiliation with the City, it is possible that SDCERS' Staff may have perceived an obligation to assist the City achieve its requests for decreased contributions to SDCERS. The Board may also consider becoming more involved in the hiring of future employees and hiring executive employees without prior City employment.

Navigant consulting understands that SDCERS' Chief Investment Officer ("CIO") is currently enrolled in the DROP program, signaling that he will be retiring from SDCERS in the next several years. If it has not contemplated succession planning for the CIO, the Board should soon begin that process.

4. Consider Eliminating the Use of "Reserves" to Fund Benefits

In the past, the SDCERS' Board, often at the request of the City, authorized the use of "reserves" to cover benefits or portions of the employee or employer contribution. To the extent that this practice continues, the SDCERS' Board may consider eliminating the creation and use of these reserves.

5. SDCERS' Internal Audit Function

Currently, the City's internal audit department conducts periodic audits of SDCERS. Navigant Consulting received copies of the internal audit reports related to SDCERS from 1996 through 2005. The SDCERS' Board, and more specifically the Audit Committee, may consider additional areas for internal audit testing.

6. Retiree Health

Addressed in the section of the report prepared by Reish Luftman.

**LEGAL ANALYSIS OF INVESTIGATIVE REPORT
ON THE
SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM**

INVESTIGATIVE REPORT PREPARED BY
NAVIGANT CONSULTING, INC.

LEGAL ANALYSIS PREPARED BY
Reish Luftman Reicher & Cohen
Los Angeles, California

January 20, 2006

LEGAL ANALYSIS

Prepared by Reish Luftman Reicher & Cohen

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I. INTRODUCTION TO LEGAL ANALYSIS

“The era of ‘rubber stamp’ boards composed of members who accept and approve staff and consultant’s proposals and recommendations without carefully evaluating and considering them is over. In evaluating the record in this case, the court found no dereliction of duties by VCERA’s board members. But this case should remind us all that board members, particularly those who are members of public pension boards, who are called on to apply complex and sophisticated actuarial methodologies, have a serious and awesome fiduciary duty in administering large amounts of public money, in a volatile investment market to ensure that such funds remain actuarial solvent to meet all current and future promised pension benefits. Failure to perform these critical fiduciary responsibilities by public pension board members, with such actions causing serious jeopardy to the actuarial soundness of the funds they administer, will, upon proper request, result in appropriate judicial action, in order to protect both public employees and taxpayers.” Tentative Statement of Decision, Mathews v. Ventura County Employees’ Retirement Association, Ventura County Superior Court, Case No. CIV220607, December 13, 2005.

A. Purpose

The purpose of this Legal Analysis is to provide an analysis of:

- the legal requirements for the conduct of fiduciaries in the administration and funding of the Retirement System; and
- the federal tax laws governing tax-qualified plans, including the Retirement System

based on Navigant Consulting’s factual findings as described in its Investigative Report.

As such, this Legal Analysis addresses the extent to which prior Boards:

- have permitted the City to interfere with the proper administration and funding of the Retirement System;
- have breached their fiduciary duties in approving MP 1 and MP 2;
- have participated in the serial underfunding of the Retirement System at the urging of the City;
- have caused the Retirement System to fail to meet certain of the requirements of a tax-qualified retirement plan under the Internal Revenue Code; and
- have violated certain other legal requirements in the performance of their duties.

The purpose of this analysis is twofold: first, to enable the current Board of Administration to formulate proper remedial actions to correct prior mistakes in the

operation of the Retirement System; and, second, to enable the current Board to adopt practices and procedures to ensure that similar breaches do not occur in the future.

The review of documents, the areas of inquiry and the factual conclusions reached by Navigant Consulting have been entirely its own. Correspondingly, the legal conclusions reached in this Section of the Report have been entirely our own (except as specifically noted elsewhere in this Section). In reaching these legal conclusions, we have relied on the facts as developed by Navigant Consulting without independent inquiry or verification. As with any legal analysis, to the extent that other facts exist that might bear on the analysis and conclusions, the conclusions stated in this Section might be different.

B. Structure

This Legal Analysis is divided into the following parts:

- **Executive Summary of Legal Conclusions.** This part contains a summary of the applicable law and legal conclusions discussed below.
- **Discussion of Legal Principles.** This part contains a discussion of the relevant legal principles that apply generally to the conduct of the Board of Administration of a California public retirement system, as well as the legal requirements that apply uniquely to SDCERS. This discussion includes:
 - An analysis of the applicable fiduciary requirements;
 - A discussion of the requirements of California law and the San Diego City Charter and Municipal Code, related to the actuarial funding of a public retirement system; and
 - A discussion of issues related to the operation of SDCERS as a qualified retirement plan under the Internal Revenue Code.
- **Discussion of Specific Findings and Issues.** In this part, the actions of prior Board with respect to the following matters are analyzed in light of the controlling legal principles discussed in the preceding part:
 - The actuarial and fiduciary conduct related to the adoption of MP 1;
 - The actuarial and fiduciary conduct related to the adoption of MP 2;
 - The operation of the Retirement System in accordance with the requirements of the Internal Revenue Code.

- **Recommendations.** At the end of this Legal Analysis Section of the Report is series of recommendations for remedial action and for practices, procedures and steps the current Board should adopt for the proper administration of the Retirement System going forward.

C. Limitations

The legal analysis and conclusions set out in this Section focus on the fiduciary aspects of the actions described by Navigant Consulting in earlier sections of this Report. . In an effort to focus this inquiry and avoid duplication of effort, and because securities law issues impact the City and are the subject of on-going investigations by the SEC and Kroll, securities law issues have not been addressed in this legal analysis. However, the facts described in this Report and the analysis of those facts in the context of the law's fiduciary and actuarial funding requirements provides material insight into the events involved in the Kroll investigation and the SEC inquiry.

Similarly, this discussion does not address potential criminal implications of prior Board member or staff actions. At the time of the preparation of this Report, criminal charges have been filed and indictments issued against certain former Board members, City officials and staff members of SDCERS. Those issues will be dealt with through the criminal justice system, and this Report can add little to the resolution of those matters. In light of the fact that the decisions in the pending criminal actions will entirely dispose of those issues, this Report does not attempt to evaluate the conduct of those parties (or others) under the criminal laws.

Conflict of interest issues arising under Government Code Sections 1090 et seq., the Political Reform Act or judicially developed conflict of interest laws relating to public officials have been left to judicial resolution. The possible violation of those conflict of interest laws bears on the legality of benefit increases given to SDCERS Members by the City and are the subject of the Retirement System's action for declaratory relief in San Diego City Employees' Retirement System v. City of San Diego, San Diego Superior Court Case No. GIC851286, which is currently pending. The decision by the Superior Court and, if pursued, the appeals courts of the State of California will fully resolve those issues. Because these matters are already the subject of litigation, and the ultimate resolution of that litigation will reach final conclusions on whether such conflicts of interest occurred – and, if so, whether the effect was to void some or all of the benefit increase granted by MP 1 or MP 2 -- we have left it to the courts to assess and resolve these issues.

In addition, the alleged violations of the conflict prohibitions in California Government Code §1090 et seq. are the basis for criminal charges filed against several former Board members by the District Attorney for the County of San Diego, the resolution of those

criminal charges may also bear on the ultimate determination of whether illegal conflicts occurred and, if so, on the consequences of those conflicts.

It is essential for the Board of Administration to pursue its declaratory relief action (referred to above). SDCERS is now, and has been, paying benefits on the premise that the increases granted by the City Council in connection with MP 1 and MP 2 are valid and enforceable. Indeed, the Board is obligated to administer the Retirement System in accordance with the terms set forth in the Municipal Code. Further, participating employees have retired based on their belief that a certain level of retirement income was available to them. However, some senior San Diego City officials have asserted that the benefit increases are void and that the resulting benefit payments should be stopped. Obviously, this conflict must be resolved by the courts. The failure of the Board to obtain a court decision, regardless of the outcome, would be untenable from a fiduciary perspective.

Finally, the facts developed by Navigant Consulting raise other issues of an ancillary nature that we are not addressing. These issues deserve further assessment, and we suggest that the Board work with its internal or outside fiduciary counsel to determine what follow up may be necessary or appropriate.

II. EXECUTIVE SUMMARY OF LEGAL CONCLUSIONS

The duties of public employee retirement system boards can be described in simple terms:

- They have a fiduciary obligation to act for the exclusive purpose of providing retirement (and possibly other) benefits to their Members. This obligation takes precedence over all other duties.
- In carrying out their duties, they must comply with the law's prudent person standard, which has been described as the highest duty known to the law. This duty requires board members to ask questions and exercise healthy skepticism.
- They must maintain the system on a sound actuarial basis.
- They must strictly follow the requirements of the laws under which the system is created, including, as applicable, the Government Code, the city charter and municipal code.
- In order to maintain the tax qualified status of the retirement system, they must follow the provisions of all documents that govern the terms of the system.
- They must oversee the administration of the system and the investment of its assets. In carrying out these duties, they must prudently appoint and monitor competent personnel to assist them.

The overriding principle behind each of these six duties is even more simply stated: they must be attentive – attentive to the task of making sure that thousands of people are able to retire with all the benefits promised to them when they started to work – and take action in compliance with the law.

Based on the Navigant Consulting findings and conclusions, we believe prior members of the Board of Administration of SDCERS did not live up to these standards.

The following is a summary of our legal conclusions:

- The funding arrangements agreed to by the Board in 1996 and 2002, in MP 1 and MP 2, respectively, failed to assure the “competency” of the Retirement System assets as required by the state Constitution.
- These funding arrangements violated the contract clauses of the state and federal Constitutions by permitting SDCERS to be significantly under funded.
- These funding arrangements violated the state Constitution’s restriction on political interference in the administration and funding of SDCERS.
- In the case of the funding arrangements under both MP 1 and MP 2, the Board of Administration breached its duty to follow the law with respect to the funding of the Retirement System and, in the process, violated the State Constitution, the Government Code, the City Charter and the Municipal Code.
- In both instances, the Board of Administration violated its fiduciary duty to the Members of SDCERS by failing to:
 - Conduct a proper investigation of the relevant facts;
 - Ask the right questions to determine the long-term impact of the funding arrangement on which they were being asked to vote;
 - Adequately supervise and monitor the SDCERS staff and the experts they engaged to assist them in assessing the proposals;
 - Thoroughly assess the concerns expressed by their fellow board members and their experts;
 - Obtain opinions from the System actuary on the propriety and long-term impacts of the proposals.
- The Board of Administration again breached its duty not to engage in activities beyond the scope of its responsibilities and to avoid participating in activities that violate the enunciated intent of Prop. 162 by entering into a contract that coupled increases in benefits with reductions in funding.
- To the extent an underfunding exists that was not corrected in connection with the Gleason settlement, the Board is obligated to consult with its actuary and legal counsel to determine the proper timing of the owed amount, how the liability will be satisfied, and if appropriate, secured.
- MP 1, MP 2, the Corbett Settlement, the Presidential Leave Benefit and the operation of the 401(h) Fund all resulted in failures to operate the Retirement

System in accordance with the documents governing its operation, which subject the Retirement System to potential disqualification as a tax-qualified plan.

- In addition, the Corbett Settlement and the Presidential Leave Benefit resulted in "overpayments," which subject the Retirement System to potential disqualification as a tax-qualified plan.
- Payment of the costs to administer the retiree health benefits program with pension assets violates the prohibited transaction restrictions of the Internal Revenue Code, which jeopardizes the tax-exempt status of SDCERS.

In addition, employment law counsel engaged to assist in the analysis of the facts developed by Navigant Consulting reached the following conclusions:

- Retirement Administrator Larry Grissom had an obligation to determine the facts and circumstances of special benefits being given to board members and failed in his legal duty to fully disclose this information to the Board.
- California law does not contain specific affirmative duties on the part of employees, either public or private, to report financial inaccuracies or wrongdoing to their employer or to governmental authorities.

A number of recommendations for future action are included at the end of the Legal Analysis.

III. DISCUSSION OF LEGAL PRINCIPLES

The purpose of this section is to establish the legal framework on which the analysis that follows is based. We discuss the fiduciary requirements imposed on the members of the Board of Administration, the actuarial principles that govern their conduct and the federal tax rules that impact the operation of the Retirement System as a qualified plan for tax purposes.

A. Outline of Applicable Laws

Several different legal principles and laws govern the administration and funding of the Retirement System. The legal principles fall into three categories, fiduciary, actuarial and tax. The laws in each category are the following:

- Fiduciary principles are found in:
 - The State Constitution;
 - California court decisions;
 - The San Diego City Charter;
 - The San Diego Municipal Code; and

- By analogy, the federal Employee Retirement Income Security Act of 1974 (ERISA) and related guidance.
- Actuarial concepts are found in:
 - The Constitution;
 - California court decisions;
 - The San Diego City Charter;
 - The San Diego Municipal Code; and
 - Generally prevailing actuarial principles.
- Tax issues are found in the Internal Revenue Code and related Treasury Regulations thereunder.

We will first discuss the fiduciary rules, then the actuarial concepts and finally the tax rules.

B. Fiduciary issues

1. California State Constitution

Pursuant to Section 143 of the City Charter of the City of San Diego (referred to hereafter as the “City Charter”), the Board has plenary authority and fiduciary responsibility for investment of moneys and administration of SDCERS, as provided in Article XVI, §17 of the California Constitution. That section provides in relevant part as follows:

“...the Board shall retain plenary authority and fiduciary responsibility for investment of moneys and administration of the system as provided for in article XVI, section 17 of the California Constitution.”

Subsections (a), (b) and (c) of Article XVI, §17 are the primary source regarding the nature and scope of the Board’s fiduciary duties respecting administration of SDCERS.

The text of Article XVI, §17, as well as its legislative history, emphasize an overall structure of the Board’s plenary and fiduciary responsibility:

- The Board has “sole and exclusive” authority over the assets of SDCERS.
- The Board has “sole and exclusive” responsibility to ensure that participants and their beneficiaries promptly receive their benefits.
- The assets of SDCERS are trust funds.
- The sole purposes of the assets of SDCERS are for providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering SDCERS.

- The Board’s fundamental duty is to the participants of SDCERS and their beneficiaries – this is referred to as the “exclusive purpose” rule, since the Constitution indicates that the Board members must act for the exclusive purpose of providing benefits to participants and states that this duty takes precedence over any other duty.
- The Board’s standard of care as to its fiduciary duty to administer SDCERS is the “prudent person” standard.

Article XVI, §17 describes these duties as follows:

“Notwithstanding any other provisions of law or this Constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system, subject to all of the following:

“(a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

“(b) The members of the retirement board of a public pension or retirement system **shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries,** minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. **A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.**

“(c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system **with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.....**” [Emphasis added]

Subsection (c) above contains the “prudent person” requirement by which the conduct of the Board members in fulfilling the exclusive purpose requirement is measured.¹

Article XVI, §17 was amended in 1992 by Proposition 162, which added the language regarding “plenary authority and fiduciary responsibility for investment of moneys and administration.”² (Note that this amendment pre-dated both MP 1 and MP 2.) Proposition 162 also added the requirements regarding “exclusive fiduciary responsibility over the assets” and “sole and exclusive responsibility to administer the system.”

Finally, Proposition 162 added the last sentence of subsection (b) indicating that a “retirement board’s duty to its participants and their beneficiaries shall take precedence over any other duty.” This sentence added clarity to the “exclusive purpose” requirement. Before the addition of that language, the three duties of providing benefits to participants, defraying reasonable expenses of administration and minimizing employer contributions had equal weight. With this addition, it became clear that the

¹ Consistent with Article XVI, §17 of the California Constitution, California Government Code §53216.6 provides that the assets of a public retirement system are trust funds and the exclusive purpose of the assets are for providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the pension system. That section reads as follows:

“The assets of the pension trust are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

“The legislative body, trust, or other body authorized to make investments for a pension trust, shall discharge its duties with respect to investing the assets of the pension trust:

“(a) Solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the trust.

“(b) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.

“(c) Shall diversify the investments of the trust so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.” [Emphasis added]

For a discussion of the applicability of this and other state law provisions to SDCERS, see Part C.3 below.

² Historical Notes, 3 West’s Ann. Const. Code (2005 ed.) art. 16, §17, p.113.

duty to provide benefits to members of the retirement system outweighs a retirement board's other obligations.

Pursuant to Proposition 162, the People of the State of California also stressed the following "findings" and "purpose and intent" of the measure:

"Section Two. Findings and Declarations. The People of the State of California hereby find and declare as follows:

"(a) Retired citizens depend upon their pension benefits to meet basic necessities such as food and shelter during their retirement years. For many elderly citizens who are not eligible to participate in Social Security, pension benefits are their sole source of financial support and security.

"(b) Teachers, firefighters, police officers and other local, school and state employees depend on promised pension benefits, which must be protected from political abuse and misappropriation.

"(c) Politicians have undermined the dignity and security of all citizens who depend on pension benefits for their retirement by repeatedly raiding their pension funds.

"(d) Political meddling has driven the federal Social Security system to the brink of bankruptcy. To protect the financial security of retired Californians, politicians must be prevented from meddling in or looting pension funds.

"(e) Raids by politicians on public pension funds will burden taxpayers with massive tax increases in the future.

"(f) To protect pension systems, retirement board trustees must be free from political meddling and intimidation.

"(g) The integrity of our public pension systems demands that safeguards be instituted to prevent political 'packing' of retirement boards, and encroachment upon the sole and exclusive fiduciary powers or infringement upon the actuarial duties of those retirement boards.

"(h) In order to protect pension benefits and to avoid the prospect of higher taxes, the People must act now to shield the pension funds of this state from abuse, plunder and political corruption.

"Section Three. Purpose and Intent. The People of the State of California hereby declare that their purpose and intent in enacting this measure is as follows:

“(a) To protect pension funds so that retirees and employees will continue to be able to enjoy a basic level of dignity and security in their retirement years.

“(b) To give voters the right to approve changes in the composition of retirement boards containing elected retirees or employee members.

“(c) To protect the taxpayers of this state against future tax increases which will be required if state and local politicians are permitted to divert public pension funds to other uses.

“(d) To ensure that the assets of public pension systems are used exclusively for the purpose of efficiently and promptly providing benefits and services to participants of these systems, and not for other purposes.

“(e) To give the sole and exclusive power over the management and investment of public pension funds to the retirement boards elected or appointed for that purpose, to strictly limit the Legislature's power over such funds, and to prohibit the Governor or any executive or legislative body of any political subdivision of this state from tampering with public pension funds.

(f) To ensure that all actuarial determinations necessary to safeguard the competency of public pension funds are made under the sole and exclusive direction of the responsible retirement boards.

(g) To affirm the legal principle that a retirement board's duty to its participants and their beneficiaries takes precedence over any other duty.
[Emphasis added]

The provisions of Article XVI, §17, particularly the exclusive purpose requirement and the prudent person rule, are virtually identical to similar provisions in the Employee Retirement Income Security Act of 1974 (“ERISA”), the federal law governing retirement plans. While ERISA by its terms does not apply to government plans³, interpretations of ERISA are instructive in understanding the California law because of the striking similarities between the two laws. The analysis of the extent to which ERISA concepts apply to California public retirement systems appears below in Part B.5.

2. Case Law

a. Nature of the Board's Fiduciary Duties.

California case law helps clarify the fiduciary relationship between retirement boards and participants in the retirement system and their beneficiaries. Furthermore, this

³ ERISA §(b)(1), 29 U.S.C. §1003(b)(1).

fiduciary relationship must be exercised pursuant to a standard of “good faith and fair dealing.” The case law also indicates that general trust law concepts in the California Probate Code apply to the nature and scope of a retirement board’s fiduciary duties.

In Masters v. San Bernardino County Employees Retirement Association,³² Cal.App.4th 30 (1995), the court held:

“‘Pension plans create a trust relationship between pensioner-beneficiaries and trustees of pension funds who administer retirement benefits ... and the trustees must exercise their fiduciary trust in good faith and must deal fairly with the pensioner-beneficiaries.’” Id. at 43.

In reaching this holding, the court explained that

“This language was repeated with approval in *Hittle v. Santa Barbara County Employees Retirement Assn.*, *supra*, 39 Cal.3d 374, 392, a case involving a county employee’s retirement association like that here. Thus, the *Hittle* court found a fiduciary duty of good faith and fair dealing: ‘The [retirement association] officers, by the acceptance of their appointment, are voluntary trustees, within the meaning of Civil Code sections 2216 and 2222 [since repealed and substantially replaced by comparable Probate Code provisions], of the retirement plans available to the beneficiary-members of the Association. [Citation.] As such, the ... officers are charged with the fiduciary relationship described in Civil Code section 2228: “In all matters connected with his trust, a trustee is bound to act in the highest good faith toward his beneficiary, and may not obtain any advantage therein over the latter by the slightest misrepresentation, concealment, threat, or adverse pressure of any kind.”’” (Id. at pp. 392-393, fn. omitted.)

In Hittle v. Santa Barbara County Employees Retirement Association, 39 Cal.3d 374 (1985), the California Supreme Court explained:

“We believe that courts must be vigilant in protecting the rights of the pensioner against powerful and distant administrators; the relationship should be one in which the administrator exercises toward the pensioner a fiduciary duty of good faith and fair dealing.’ (Citation omitted.)” Id. at 393 [emphasis added].

California Civil Code §§2216, 2222, 2228 and 2235 were repealed effective July 1, 1987, and were superseded in large part by substantially similar Probate Code sections.⁴ The

⁴ Disposition Table, 10A West’s Ann. Civil Code (2006 ed.), Cumulative Pocket Part, p.2. Former §2216 was not superseded by any statute, but former §2222 was superseded by Probate Code §§15200-15207 and 15600. Id. Former Sections 2228 and 2235 were superseded by Probate Code Section 16002 and 16004, respectively. Id.

most relevant section is Probate Code §16002, which addresses a trustee's fiduciary duties and is discussed in Part B.3 below.

Another case that discusses the duty to protect the interests of the participants in a public employee retirement system over the interests of the sponsoring governmental entity is City of Sacramento v. Public Employees Retirement System, 229 Cal.App.3d 1470 (1991). In that case, the City brought a declaratory relief action against the Public Employees Retirement System ("PERS") seeking a declaration that the extra one-half hour overtime premium pay required by the federal Fair Labor Standards Act ("FLSA") (29 U.S.C. §§ 201-219) constitutes overtime as defined under Gov. Code, §§ 20022, 20025.2, and that therefore such pay received by city firefighters for work falling within the firefighters' normal work schedule was not compensation for which retirement contributions were required to be made. Id. at 1475. The Board of Administration of PERS had determined that such premium pay was compensation for retirement purposes. Id.

The trial court entered judgment in favor of the city, based on the City's argument that that because PERS' interpretation would increase the City's costs, the PERS board's interpretation violated Article XVI, §17(b) because it conflicted with the direction to "minimize employer contributions." Id. at 1493. (Note that this case was decided before the amendment to the Constitution that added the statement that the primary duty of retirement system fiduciaries was to provide benefits to the participants.)

On appeal, the court reversed the trial court's decision and found in favor of the PERS' determination that the overtime pay was compensation on which benefits would be based. In dismissing the City's argument, the court stated that "[t]he City's argument is an unfounded expansion of the employer minimization provision which ignores its context in the article as a whole." Id. The court went on to explain:

"We agree with PERS that, even assuming article XVI, section 17 creates a duty to minimize employer contributions, **it cannot be construed to require PERS to manage the retirement system in a way which would favor an employer over the beneficiaries to whom it owes a fiduciary duty....**

"Under the rule against divided loyalties, a 'fiduciary cannot contend "that although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of his secondary one."' (Id. at p. 330 [69 L.Ed.2d at p. 680].)

"Any duty PERS has to minimize employer contributions may not take precedence over its duty to the beneficiaries of the system. Accordingly, we hold **that the 'employer minimization' provision of California Constitution article XVI, section 17 does not require PERS, as the fiduciary of the retirement**

system, to alter legitimate interpretations of ‘compensation’ in a manner which is detrimental to its beneficiaries.” *Id.* at 1493-1494 [Emphasis added].

The implications of this decision in the context of MP 1 and MP 2 will be discussed in detail in Part IV below, but even before the 1992 amendment, the California courts were prepared to recognize that minimization of employer contributions was secondary to the primary purpose of providing benefits to the members of a public retirement system.

b. Permissible Change in Benefits

Vested pension rights of a public employee are obligations protected by the contract clauses of the federal and state Constitutions. See, Valdes v. Cory, 139 Cal.App.3d 773, 783-784 (1983); Abbott v. City of San Diego, 165 Cal.App.2d 511, 517 (1959). While pension rights may be modified, California case law has set specific limits regarding the scope of such modifications. In particular, these limits apply when steps are taken to reduce the amount of employer contributions to a retirement system.

Because this constitutional limitation on modifying vested benefits and on failing to fund a retirement system on an actuarially sound basis raises significant fiduciary issues, the case law in this area is discussed in some detail below. (This issue also arises in the actuarial context and is discussed further in Part C below.)

Although a public employees’ vested pension rights can be modified, the modification must be reasonable, a determination to be made by the courts on a case-by-case basis. United Firefighters of Los Angeles City v. City of Los Angeles, 210 Cal.App.3d 1095, 1102 (1989). A court looks to the following elements in determining whether a modification of a public employee’s pension rights is reasonable: (1) alterations of a public employees’ pension rights must bear some material relation to the theory of a pension system and its successful operation, and (2) changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages. *Id.* at 1103.

In the United Firefighters case, the court explained the issues as follows:

“[I]t is the advantage or disadvantage to the particular employees whose own contractual pension rights, already earned, are involved which are the criteria by which modifications to pension plans must be measured.” [Citation.]’ (Miller, *supra*, 18 Cal.3d at p. 816.)” *Id.*

In Board of Administration v. Wilson, 52 Cal.App.4th 1109 (1997), the state Public Employees’ Retirement System (“PERS”) filed a petition for writ of mandate and complaint for declaratory relief, alleging that two statutory amendments (Senate Bill (SB) 1107 and SB 240) changing the funding of PERS to an “in arrears” system, under which contributions were not paid during that same fiscal year that employee services

were rendered, violated the contract clauses of the Federal and California State Constitutions. Id. at 1121-24. The lower court ruled that “in arrears” financing was an unconstitutional impairment of contract, in part based on the fact that the State failed to provide comparable new advantages in exchange for the adverse effect of in-arrears financing. Id. at 1123.

In affirming the lower court’s ruling, the Court of Appeal addressed the Governor’s contention that it was not required to provide any comparable new advantage because a comparable new advantage is required only in cases of modification of a pension benefit. Id. at 1145. The Court of Appeal rejected this argument stating that “the controlling principle applies to modification of any ‘vested contractual pension right.’” Board of Administration v. Wilson, supra, 52 Cal.App.4th at 1145; see, also, Valdes v. Cory, supra, 139 Cal.App.3d 773, 784.

In Claypool v. Wilson, 4 Cal.App.4th 646 (1992), members of PERS and their employee organizations applied for a writ of mandate challenging a statute which, among other modifications to PERS, repealed supplemental cost of living programs in exchange for new cost of living (“COLA”) programs and enacted new supplemental COLA programs. Id. at 657-658. The Court of Appeal held that the new supplemental COLA programs were a reasonable modification of the pension rights of PERS members. Id. at 665-670.

In reaching this decision, the Claypool court first determined that the changes in the supplemental COLA programs bore a material relation to the theory of PERS and its successful operation. Id. at 665-666. Petitioners argued that the new supplemental COLA programs lacked the requisite relation to the theory of a pension system and its successful operation because the purpose of the legislation was to alleviate a state budget deficit. Id. at 665. In rejecting this argument, the court explained that the saving of public money was not an illicit purpose if changes in the pension program are accompanied by comparable new advantages to the employee. Id. Indeed, the court stated that if the saving of public money were an improper purpose in motivating changes to a pension program, the reasonable modification doctrine would add little flexibility to the administration of the public pension system. Id. at 665-666.

The court elaborated:

“The justification must relate to considerations internal to the pension system, e.g., its preservation or protection or the advancement of the ability of the employer to meet its pension obligations. Changes made to effect economies and save the employer money do ‘bear some material relation to the theory of a pension system and its successful operation’ That is not to say that a purpose to save the employer money is a sufficient justification for change. The change must be otherwise lawful and must provide comparable advantages to the employees whose contract rights are modified. We hold only that the monetary objective will not invalidate a modification which is otherwise valid.” Id. at 666 [citation omitted].

The court determined that the Legislature could validly amend the statutes governing PERS by the addition of a second tier of noncontributory employees, the effect of which would have been to erase the benefits to members with vested rights in certain features of PERS that existed before the amendment. *Id.* at 669-670. The court recognized that the loss of the potentially higher level of benefits under the former supplemental COLA programs was a disadvantage to employees, but concluded that the new COLA programs provided an obvious new advantage for such members -- actual benefits for the theoretical but illusory higher benefits under the repealed programs. *Id.* at 668-669.

3. California Law Provisions

The California Government Code contains provisions that are consistent with Article XVI, §17 of the California Constitution and impose virtually identical requirements. The language of Government Code §53216.6 is quoted at footnote 1 above. Other provisions of the Government Code dealing with actuarial issues are discussed in Part C.2 of this Section, below. In addition, the principles of the California Probate Code also apply in interpreting the fiduciary responsibilities of public retirement system boards.

As discussed below, these provisions impose on trustees (and effectively the boards of public retirement systems) the following responsibilities and liabilities:

- The trustees owe a duty of loyalty to the beneficiaries of the trust, which means an obligation to act in the best interest of the beneficiaries at all times.
- The trustees may not delegate duties they can reasonably be expected to perform themselves, but if they do delegate any of their duties, they must do so prudently, they remain responsible for the acts of the agents they appoint and they must prudently appoint and supervise the performance by the agent.
- The trustees are responsible for the acts of co-trustees in certain circumstances.

a. Applicability of the Probate Code

California case law indicates that the Probate Code provisions are helpful in determining the nature and scope of a retirement board's fiduciary duties. *See, e.g., Masters v. San Bernardino County Employees Retirement Association, supra*, 32 Cal.App.4th 30, 44, and *Hittle v. Santa Barbara County Employees Retirement Association, supra*, 39 Cal.3d 374, 393. While Probate Code §82 indicates that retirement plans are not generally treated as "trusts" for purposes of the Probate Code provisions,⁵ the law makes it clear that the principles set forth in the Code may be applied to arrangements that are otherwise considered trust relationships, such as public retirement plans. Thus, Probate Code §15003 provides:

⁵ California Probate Code §82(b) provides: "'Trust' excludes the following: * * * (13) Trusts for the primary purpose of paying debts, dividends, interest, salaries, wages, profits, pensions, or employee benefits of any kind." [Emphasis added]

“(c) Nothing in this division or in Section 82 is intended to prevent the application of all or part of the principles or procedures of this division to an entity or relationship that is excluded from the definition of ‘trust’ provided by Section 82 where these principles or procedures are applied pursuant to statutory or common law principles, by court order or rule, or by contract.” [Emphasis added]

Further, the cases of City of Sacramento v. Public Employees Retirement System, *supra*, 229 Cal.App.3d 1470 and Herrick v. The State of California, (1983) 149 Cal.App.3d 156 support the application of the California Probate Code to the San Diego City Employees’ Retirement System (“SDCERS”).

In City of Sacramento v. Public Employees Retirement System, *supra*, 229 Cal.App.3d 1470, immediately after quoting Article XVI, Section 17(a), (c) and (d) of the California Constitution, the court states:

“Under well-established rules of the law of trusts, a trustee’s primary duty of loyalty is to the beneficiaries of the trust. ‘The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary.’ (Rest.2d Trusts (1950) § 170, subd. (1), p. 364.)” *Id.* at 1494.

An additional example of the application of the Probate Code principles to retirement plan can be seen in In re Kuraishi, 237 B.R. 172 (Bankr.C.D.Cal.1999), in which the United States Bankruptcy Court for the Central District of California held:

“The definition section of the CPC excludes from the definition of ‘trusts’ those that are for the primary purpose of paying pensions or employee benefits of any kind. See Cal. Prob. Code § 82(b)(13) (West 1999). However, this section does not necessarily render the statutes in Division 9 inapplicable. California Probate Code § 15003 provides....” *Id.* at 175.

The court concluded that the principles of the Probate Code could be applied to a retirement plan.

b. Probate Code Provisions

California Probate Code §16002, “Duty of Loyalty,” provides that “(a) The trustee has a duty to administer the trust solely in the interest of the beneficiaries.” For purposes of the analysis of the obligations of the SDCERS Board of Administration, the term “trustee” should be read to include the members of the Board. After describing the duty of loyalty, Probate Code §16012 then set out rules with respect to the obligations of the trustee to manage the trust and supervise others who are engaged to assist the trustee:

“(a) The trustee has a duty not to delegate to others the performance of acts that the trustee can reasonably be required personally to perform and may not transfer the office of trustee to another person nor delegate the entire administration of the trust to a co-trustee or other person.

“(b) In a case where a trustee has properly delegated a matter to an agent, co-trustee, or other person, the trustee has a duty to exercise general supervision over the person performing the delegated matter.”

With respect to the duties related to the selection of others to assist the trustee, California Probate Code §16052 provides:

“(a) A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following:

- “(1) Selecting an agent.
- “(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.
- “(3) Periodically reviewing the agent’s overall performance and compliance with the terms of the delegation.

“(b) In performing a delegated function, an agent has a duty to exercise reasonable care to comply with the terms of the delegation.”

California Probate Code §16401 addresses the issue of the trustee’s responsibility for the acts of agents appointed by it. The section provides:

“(a) Except as provided in subdivision (b), the trustee is not liable to the beneficiary for the acts or omissions of an agent.

“(b) Under any of the circumstances described in this subdivision, **the trustee is liable to the beneficiary for an act or omission of an agent** employed by the trustee in the administration of the trust that would be a breach of the trust if committed by the trustee:

- (1) Where the trustee directs the act of the agent.
- (2) Where the trustee delegates to the agent the authority to perform an act that the trustee is under a duty not to delegate.
- (3) Where the trustee does not use reasonable prudence in the selection of the agent or the retention of the agent selected by the trustee.
- (4) Where the trustee does not periodically review the agent's overall performance and compliance with the terms of the delegation.
- (5) Where the trustee conceals the act of the agent.

- (6) Where the trustee neglects to take reasonable steps to compel the agent to redress the wrong in a case where the trustee knows of the agent's acts or omissions." [Emphasis added]

The next section of the Probate Code, §16402, addresses the liability of one trustee for the acts or omissions of a co-trustee. The section provides:

- "(a) Except as provided in subdivision (b), a trustee is not liable to the beneficiary for a breach of trust committed by a co-trustee.
- "(b) A trustee is liable to the beneficiary for a breach committed by a co-trustee under any of the following circumstances:
 - (1) Where the trustee participates in a breach of trust committed by the co-trustee.
 - (2) Where the trustee improperly delegates the administration of the trust to the co-trustee.
 - (3) Where the trustee approves, knowingly acquiesces in, or conceals a breach of trust committed by the co-trustee.
 - (4) Where the trustee negligently enables the co-trustee to commit a breach of trust.
 - (5) Where the trustee neglects to take reasonable steps to compel the co-trustee to redress a breach of trust in a case where the trustee knows or has information from which the trustee reasonably should have known of the breach."

4. Applicable City of San Diego Requirements

As discussed in Part III.B.1., the Board can make and enforce all rules and regulations regarding the administration of SDCERS. In addition to limitations imposed by the California Constitution and applicable state law discussed above, the Board's power to administer SDCERS is governed by the City Charter. The City Charter and the San Diego Municipal Code also regulate the nature and scope of the Board's fiduciary duties with regard to the administration of SDCERS.

a. The City of San Diego City Charter

Article IX, §143 of the City Charter, "Contributions," provides in relevant part as follows:

"[T]he Board shall retain plenary authority and fiduciary responsibility for investment of moneys and administration of the system as provided for in article XVI, section 17 of the California Constitution." [Emphasis added].

Article IX, §144 of the City Charter, "Board of Administration," provides:

“The Board of Administration shall be the sole authority and judge under such general ordinances as may be adopted by the Council as to the conditions under which persons may be admitted to benefits of any sort under the retirement system; and **shall have exclusive control of the administration and investment of such fund or funds as may be established**” [Emphasis added]

Article IX, §145 of the City Charter, “Retirement Fund,” makes it clear that SDCERS is a trust fund (thus indirectly making the Probate Code provisions discussed above applicable to it). That section provides:

“All moneys contributed by employees of the City or appropriated by the Council or received from any other source under the terms of this Article, shall be placed in a special fund in the City Treasury to be known as the City Employees’ Retirement Fund, which said fund is hereby created. **Such fund shall be a Trust Fund to be held and used only for the purposes of carrying out the provisions of this Article.**” [Emphasis added]

These sections of the City Charter confirm that the Board of Administration has plenary authority and fiduciary responsibility over SDCERS and provided in the State Constitution and that the funds held by SDCERS are trust funds that must be held for the exclusive purpose of providing benefits.

b. San Diego Municipal Code

The San Diego Municipal Code also contains provisions describing the terms of the Retirement System and the obligations of the Board and the City with respect to it. Most of the relevant sections deal with actuarial issues that are discussed in Part B.4.b. below. However, one section points out the obligation of the Board to provide information to the Members and the City regarding the funded status of the Retirement System.

Municipal Code §24.0911, “Annual Report,” is relevant in that it describes the duties of the Board and SDCERS staff to provide relevant information to the City and Members regarding the Retirement System. It provides in part:

- “(a) The Retirement Board shall prepare an Annual Report at the end of each fiscal year to provide information to all Members concerning the System. Copies of the Annual Report shall be distributed to all Members. The Retirement Administrator shall keep a copy of the Annual Report in his or her office.
- “(b) The President of the Retirement Board shall provide the Annual Report to the City Manager and the City Council, shall inform the City Manager

and the City Council semi-annually of the funding status of the pension system, the impact of any demographic or actuarial issues, and any other changes affecting the benefits or funding of the Retirement System that have occurred since the date of the previous semi-annual report pursuant to this section.

- “(c) **The President of the Retirement Board and the Retirement Administrator shall promptly inform the City Manager and the City Council of all material facts or significant developments relating to all matters under the jurisdiction of the Board,** except as may be otherwise controlled by the laws and regulations of the United States or the State of California.” [Emphasis added]

5. The Employee Retirement Income Security Act of 1974 (ERISA)

As noted above, ERISA (which is the federal law that generally governs retirement plans) does not apply to plans established by government entities, such as SDCERS. That said, the legislative history of Article XVI, §17 of the California Constitution indicates that the Legislature intended that the retirement board of a public pension system discharge their duties pursuant to a standard that is virtually identical to the statutory standards set forth in ERISA. Therefore, the statutory framework of ERISA and interpretations of that statute are instructive as to the nature and scope of the Board’s fiduciary duty to administer SDCERS.

a. Legislative History of Article XVI, §17

Prior to the amendments made in 1992 by voter initiative pursuant to Proposition 162, California Constitution, Article XVI, §17 read as follows:

“Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement system, subject to all of the following:

“(a) The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

“(b) The fiduciary of the public pension or retirement system shall discharge his or her duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system.

“(c) The fiduciary of the public pension or retirement system shall discharge his or her duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.

“(d) The fiduciary of the public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.”

This language, proposed by Assembly Constitutional Amendment (“ACA”) No. 16 (1983), was approved by the voters at the primary election held June 5, 1984. Historical Notes, 3 West’s Ann. Const. Code (2005 ed.) art. 16, §17, p.113. In describing the reasons for and bases of these provisions, ACA No. 16, filed with Secretary of State September 8, 1983, stated as follows:

“The Constitution presently provides that, notwithstanding specified provisions to the contrary, the Legislature may authorize the investment of moneys of any public pension or retirement fund, subject to specified conditions relating to the percentage of assets which may be invested and the types of stocks and corporations which may be invested in.

“This measure would:

“(1) Delete the specified conditions on the investment of moneys of a public pension or retirement fund, and would instead provide that the Legislature may authorize the investment of moneys of any public pension or retirement system subject to specified duties of the fiduciary of the public pension or retirement system.

“(2) Provide that the assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits and defraying reasonable administrative expenses.

“(3) Provide that the fiduciary shall: (a) discharge the duties solely in the interest of the participants and beneficiaries and for the exclusive purposes of providing benefits, minimizing employer contributions, and defraying reasonable administrative expenses; (b) **discharge the duties pursuant to a specified standard which is substantially similar to the statutory standard for the State Teachers’ Retirement System and the standard in the federal Employee Retirement Income Security Act of 1974;** and (c) diversify the investments so as

to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so. [Emphasis added]

Thus, it appears that it was the intent of both the California Assembly and Senate that the fiduciary duties set forth in California Constitution, Article XVI, §17 follow the standard set forth in the Employee Retirement Income Security Act of 1974 (“ERISA”).

b. Guiding ERISA Principles

The following discussion of ERISA, U.S. Department of Labor (DOL) regulations adopted under ERISA, other DOL guidance and case law under ERISA is intended to provide guidance that may be used by analogy where California authorities have not addressed relevant fiduciary responsibility issues under the exclusive purpose and prudent person rules of the California Constitution, Government Code and other authorities.

i. Fiduciary Duties Generally

The duties of fiduciaries under ERISA are set out in Section 404(a)(1). That section requires that fiduciaries fulfill the following requirements:

“...a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and –

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying the reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims....”

These rules are virtually identical to those set out in California Constitution Article XVI, §17.

The key requirement appears in subsection (A), the “exclusive purpose” rule: fiduciaries must act in a manner consistent with providing retirement benefits for the participants. The standard used in measuring the conduct of the fiduciaries in doing that job is found in subsection (B), the prudent man requirement.

The prudent person rule includes both the duty to monitor and the duty to investigate, discussed below.

In discussing the duties of fiduciaries (in the context of investments), the U.S. Department of Labor (the “DOL”) has explained the prudent man requirement as follows [ERISA Regulation Section 2550.404a-1, 29 C.F.R. §2550.404a-1], the DOL states:

“With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act...are satisfied if the fiduciary (A) **has given appropriate consideration to those facts and circumstances that...the fiduciary knows or should know are relevant** to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan’s investment portfolio with respect to which the fiduciary has investment duties; **and (B) has acted accordingly.**” [Emphasis added]

As the highlighted language of this Regulation indicates, there are several factors that fiduciaries must consider in fulfilling their fiduciary duties; that is, in order to engage in a prudent process for making decisions:

1. The fiduciaries must determine which “facts and circumstances” are relevant to making a prudent decision.
2. The fiduciaries then must collect the information that is “relevant” to making an informed decision. This information must include not only what the fiduciary “knows” is significant to the decision, but also what he “should know” is relevant. The “should know” requirement creates an obligation to investigate and/or to hire an expert in order to fully understand the issues to be decided and to prepare the information, data or advice that is relevant to the decision-making process.
3. The fiduciaries must then “give appropriate consideration” to the relevant information. That is, they must review and evaluate the relevant information as a basis for making a decision that is both informed and reasoned. As part of this process, they may engage experts to assist them in the analysis, but they must prudently select the experts and evaluate their advice; they may not rely “blindly” on their advisors. This means that fiduciary decisions must be “informed” by the fiduciaries’ review of the relevant information and must be “reasoned” in the sense that it has a reasonable connection to that information.
4. The fiduciaries must then reach a decision on the basis of the analysis they have undertaken and the assessment they have made of the information they have considered and the advice they have received.
5. Finally, the fiduciaries must act on, they must implement, that decision.

The following discussion from Acosta v. Pacific Enterprises, 950 F.2d 611, 615-616 (9th Cir. 1992), is instructive in elucidating fiduciary duties under ERISA. (The facts and specific holding of the case are not relevant for purposes of this Report. The case involved the question of whether a participant was entitled to obtain a list of all other participants in the plan who held company stock in their accounts in order to solicit their votes at the company's annual meeting for a candidate for a directorship of the company. The court concluded that the participant did not have such a right. Nonetheless, the principles discussed in the case are essential to understanding the fiduciary duties of the Board of Administration.) In describing the duties of fiduciaries, the court said:

“Although ERISA is a ‘comprehensive and reticulated statute,’ [citations omitted], it does not purport to state expressly each and every one of a fiduciary's duties. Rather, ERISA's legislative history demonstrates that ‘Congress invoked the common law of trusts to define the general scope of [a fiduciary's] authority and responsibility.’ [citations omitted] The language of section 404(a) reflects this congressional intent that common law trust principles animate the fiduciary responsibility provisions of ERISA. Under ERISA, a fiduciary is required to discharge its duties ‘solely in the interest of the participants and beneficiaries,’ 29 U.S.C. § 1104(a)(1) (1988), and ‘with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims,’ *id.* § 1104(a)(1)(B).

However, section 404(a) further provides that a fiduciary must discharge its duties ‘for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.’ *Id.* § 1104(a)(1)(A). The legislative history of section 404(a) cautions that ‘courts [should] interpret the prudent man rule and other fiduciary standards bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by the Act.’ [citation omitted] In sum, we agree that the common law of trusts informs the duties of an ERISA fiduciary; at the same time, however, we recognize that a fiduciary's duties are circumscribed by Congress’ overriding goal of ensuring ‘the soundness and stability of plans with respect to adequate funds to pay promised benefits.’ 29 U.S.C. § 1001 (1988).

Other circuits, applying a similar analysis, have recognized that an ERISA fiduciary's duty to disclose information to beneficiaries is not limited to the dissemination of the documents and notices specified in 29 U.S.C. sections 1021-1031, but may in some circumstances extend to additional disclosures where the interests of the beneficiaries so require....Thus, an ERISA fiduciary has an

affirmative duty to inform beneficiaries of circumstances that threaten the funding of benefits [citation omitted]....”

ii. The Duty to Investigate

The requirement to act prudently in administering a retirement plan has two parts: the conduct required of the fiduciaries and the results they are expected to achieve. In evaluating fiduciary conduct, the courts look at “procedural prudence” – that is, the process used in making decisions. Of course, the courts also look at the quality of the fiduciaries’ decisions. As the court said in Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996):

“To enforce [ERISA’s fiduciary duties], the court focuses not only on the merits of the transaction, but also on the thoroughness of the investigation into the merits of the transaction.”

And another court explained in the context of investment duties (though the principle would apply to all duties of a fiduciary):

“It is by now black-letter ERISA law that ‘the most basic of ERISA’s investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of a particular investment.’ In Re Unisys Savings Plan Litig., 74 F.3d 420, 435 (3rd Cir 1996).” Liss v. Smith, 991 F. Supp. 278, 297 (SDNY 1998).

The dual obligations under the prudence requirement have perhaps best been described in an opinion written by then Circuit Judge, now Supreme Court Justice, Antonin Scalia: “in short,” he said, “there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently.” Fink v. National Savings and Trust Company, 772 F.2d 951, 962 (DC Cir 1984).

Stated another way, the requirements necessary to meet the prudent person rule consist of “procedural prudence,” which is the process of investigating, deliberating and deciding, and “substantive prudence,” or the duty to review the “substance,” the right information, and to make a reasoned decision – that is, a decision reasonably based on the relevant facts.

In commenting on the process to be used in selecting a provider from which to purchase annuities for a pension plan, the DOL said that:

“....plan fiduciaries [must] conduct an objective, thorough and analytical search.... In conducting such a search, a fiduciary must evaluate a number of factors [and] reliance solely on [one set of criteria] would not be sufficient to

meet this requirement.” DOL Interpretive Bulletin 95-1(c), 29 C.F.R. §2509.95-1(c).

This Regulation highlights that fiduciaries must conduct a thorough investigation and a rigorous consideration of the relevant information before making decisions about the administration and funding of a pension plan.

In the case of Lanka v. O'Higgins, 810 F.Supp. 379 (N.D. NY 1992), the court described the fiduciary prudence requirement (again, specifically in the context of investments) as follows:

“Rather, the prudent person standard has been determined by the courts to be an objective standard, requiring the fiduciary to (1) employ proper methods to investigate, evaluate and structure the investment; (2) act in a manner as would others who have a capacity and familiarity with such matters; and (3) exercise independent judgment when making investment decisions. [citations omitted]”

Finally, in Barker v. American Mobil Power Corporation, 64 F.3d 1397 (9th Cir. 1995), the court concluded that a fiduciary of a profit sharing plan breached his duty by failing to investigate whether the plan sponsor had properly contributed funds to the plan and established accounts for all participants. Had the fiduciary done so, he would have discovered that funds were missing from the plan, which resulted in a loss of benefits to participants involved in the lawsuit. Although the case involved a defined contribution plan and not a pension plan (like SDCERS), the court’s conclusion regarding the failure to investigate the adequacy of plan funding is apt and instructive. The court said:

“A fiduciary has a duty to act in the best interests of the plan participants and beneficiaries. **Not to investigate suspicions that one has with respect to the funding and maintenance of the plan constitutes a breach of that duty.**” Id. at 1403. [Emphasis added]

In essence, what all of these authorities are describing is the fact that fiduciaries must engage in a *process*. But a *process* by itself is not sufficient. The *process* must involve investigation of relevant information; it must involve evaluation of that information; it must involve action consistent with the information obtained; and it must involve independent judgment on the part of the fiduciaries. And as previously noted, it must involve gathering and evaluating not only the information the fiduciaries know, from their own experience and knowledge base, is relevant but also the information they *should know* is relevant. The use of experts and others to assist the fiduciaries is discussed further in Part 5.b.4. below.

iii. The Duty to Monitor

The job of the fiduciaries is not complete when they have made an initial prudent decision. They still have an on-going duty to periodically review the decisions they have made and to decide whether their initial decisions remain valid in light of changed circumstances. Under ERISA, this is called the “duty to monitor,” and is derived in part from the requirement stated in the prudent person rule to take into consideration the “circumstances then prevailing.”

In describing the obligations of fiduciaries, the courts have said that “ERISA fiduciaries must monitor investments with reasonable diligence and dispose of investments which are improper to keep.” Morrissey v. Curran, 567 F.2d 546, 548-49 (2d Cir. 1977) And again: “Once an investment has been made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper.” Harley v. Minnesota Mining and Manufacturing Company, 42 F.Supp.2d 898 (D.Minn. 1999)

The duty to monitor applies to more than just the investments. The fiduciaries have an obligation to monitor, remove and replace service providers. This obligation is described by the DOL in its Interpretive Bulletin 96-1 relating to the providers of investment education and investment advice in 401(k) plans:

“As with any designation of a service provider to a plan, the designation of a person(s) to provide investment education services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan; therefore, **persons making the designation must act prudently and solely in the interests of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designations(s).**” [Emphasis added]

In a broader context, these court decisions and statement by the DOL indicate that the fiduciaries have a duty to re-evaluate their decisions periodically and make new decisions if circumstances have changed that make the original decision no longer valid. This requirement is effectively codified in the requirements of the City Charter and Municipal Code by requiring annual valuations for funding purposes and periodic evaluation of the experience that goes into the actuarial calculations for funding purposes.

So, it is not enough for fiduciaries to act prudently and in the best interests of the participants to begin with. They must periodically review their decisions, gather more relevant information and go through a process of re-evaluation to determine whether to reaffirm or change their original decision.

iv. Reliance on Experts

Not everyone who becomes a fiduciary – who serves on the board of a public retirement system – is an expert in running a retirement plan or making decisions about the proper funding of such a plan. ERISA recognizes this fact and permits fiduciaries (indeed, sometimes requires them) to rely on third parties, both experts that are fiduciaries and providers that are not fiduciaries, in fulfilling their duties.

A. Selection of an Expert

The DOL has stated that fiduciaries must seek help if they are not able to fulfill their duties themselves. In one regulation, the DOL said: “Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.” DOL Interpretive Bulletin 95-1(c)(6), 29 C.F.R. 2509.95-1(c)(6). Soon after ERISA was enacted, the DOL discussed whether fiduciaries could properly discharge their duties if they relied on others to provide them with information. In approving this practice, the DOL stated:

“A plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention **if, in the exercise of ordinary care in such situation, he has no reason to doubt the competence, integrity or responsibility of such persons.**” [Emphasis added] DOL Interpretive Bulletin 75-8, Q&A FR 11, 29 C.F.R. 2509.75-8 at FR 11.

The highlighted language in the foregoing quote is important in the context of SDCERS and the Board’s reliance on its actuarial consultant and staff members.

The courts have adopted a view similar to that of the DOL, one court explaining that “Fiduciaries need not become experts in employee benefits, and may rely on independent expert advice...” Gregg v. Transportation Workers of America International, 343 F.3d 833, 843 (6th Cir 2003).

In fact, the courts recognize that use of an expert may actually be required in order for fiduciaries to fulfill their duties. As the court in Liss v. Smith, *supra*, 991 F.Supp. 278, 297 (S.D.N.Y. 1998), stated:

“where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors.” See also United States v. Mason Tenders Dist. Council of Greater New York, 909 F.Supp. 882, 886 (S.D.N.Y. 1995); Trapani v. Consolidated Edison Employees’ Mutual Aid Society, 693 F.Supp. 1509, 1516 (S.D.N.Y. 1988).

B. Extent of Reliance

While fiduciaries may – and sometimes must – use experts or others, there is a question of the extent of that reliance. For example, as the court said in Bisceglia v. Bisceglia, 17 F.3d 393 (9th Cir. 1994):

“Although reliance on an adviser will not immunize a trustee’s [or other fiduciary’s] actions, it is a factor to be weighed in determining whether a trustee breached his or her duty.”

In general, the courts in ERISA cases take the position that fiduciaries must make their own decisions even though they are entitled to rely on the advice and assistance of others. For example, as the court in Gregg v. Transportation Workers of America International, *supra*, at 841, said:

“While a trustee has a duty to seek independent advice where he lacks the requisite education, experience and skill [citation omitted], **the trustee nevertheless must make his own decision based on that advice.**” [Emphasis added]

This requirement was reiterated in Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983), where the court said that a fiduciary

“is not justified . . . in relying wholly upon the advice of others, *since it is his duty to exercise his own judgment in light of the information and advice which he receives.*” *Id.* at 1234 [bold added; italics in original] [Emphasis added]

Indeed, the fiduciaries must still reasonably review, understand and approve the advice they receive. In Bussian v. RJR Nabisco, Inc., 223 F.2d 286, 300-01 (5th Cir. 2000), the court described the duty of fiduciaries with respect to expert assistance as follows:

“Fiduciaries...are entitled to rely on the advice they obtain from independent experts. **Those fiduciaries may not, however, rely blindly on that advice.** In order to rely on an expert’s advice, a ‘fiduciary must (1) investigate the expert’s qualifications, (2) provide the expert with complete and accurate information, and (3) make certain that reliance on the expert’s advice is reasonably justified under the circumstances.’” [Emphasis added]

At the same time, courts recognize that fiduciaries are not required to have the same level of expertise as their consultants or to duplicate their work. As the court said in In re Unisys Sav. Plan Litig., 74 F.3d 420, 435 (3d Cir. 1996):

“we would encourage fiduciaries to retain the services of consultants when they need outside assistance to make prudent investments and do not expect fiduciaries to duplicate their advisers’ investigative efforts. . . .”

Thus, the duty of fiduciaries is to engage outside help when they need it, to ask questions about the advice they receive to ensure they understand it and only then to take action in reliance on that advice. Nevertheless, the fiduciaries do not need to become experts themselves in order to fulfill their duties.

c. Summary of ERISA Rules

In summary, the ERISA rules are consistent with the mandate of the California Constitution and, through incorporation, the San Diego City Charter. Accordingly, the following ERISA concepts are applicable to the boards of administration of public retirement systems in California:

- The fiduciaries must act for the exclusive purpose of providing retirement benefits to the participants.
- The fiduciaries must meet the prudent person rule in carrying out their duties, which requires them to engage in a prudent process in making decisions.
- The prudent person rule consists of procedural prudence and substantive prudence.
- The prudent process requires the fiduciaries to undertake an investigation to obtain all relevant information, both what they know is relevant and what they should know is relevant.
- The fiduciaries may rely on experts and others to assist them in carrying out their duties so long as they have no reason to doubt the competence, integrity or responsibility of such persons.
- The fiduciaries may rely on experts and others but must make their own independent judgment once they receive that assistance. They may not rely blindly on the advice of experts.
- The fiduciaries must make informed and reasoned decisions once they have gathered and analyzed the relevant information.

C. Actuarial Rules

One of the Board’s principal functions is to determine the proper amount to be contributed by the City to pay for the benefits promised to City employees. While the City Council is responsible for setting the benefits – through the meet and confer process with the labor unions representing the City’s employees and through amending the Municipal Code – it is up to the Board to tell the City how much it must contribute to

pay its share of cost of the promised benefits.⁶ In determining these amounts, the Board is required to follow actuarial rules under the State Constitution, judicially developed legal principles, the California Government Code, the City Charter, the Municipal Code and generally accepted actuarial principles. The obligations imposed by these differing sets of rules vary and in some cases may appear to be in conflict; our legal analysis must take each into account. We discuss each below.

1. California Constitution

The broadest statement of actuarial requirements appears in the California Constitution. Article XVI, Section 17(e) provides:

“The retirement board of a public pension or retirement system, consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system.”
[Emphasis added]

Subsection (e) was added to Article XVI, §17 by initiative in 1992 pursuant to Proposition 162, “The California Pension Protection Act of 1992.” The text of the proposed law provided, in part:

“Section Two. Findings and Declarations. The People of the State of California hereby find and declare as follows:

* * *

“(e) Raids by politicians on public pension funds will burden taxpayers with massive tax increases in the future.

“(g) The integrity of our public pension systems demands that safeguards be instituted to prevent political ‘packing’ of retirement boards, and encroachment upon the sole and exclusive fiduciary powers or infringement upon the actuarial duties of the retirement boards.

“Section Three. Purpose and Intent. The People of the State of California hereby declare that their purpose and intent in enacting this measure is as follows:

* * *

⁶ There are three elements of required contributions to SDCERS: amounts contributed by employees to fund a portion of the benefit, amounts contributed by the City on behalf of employees – the so-called “pickup” amount – to pay for a portion of the benefit and amounts contributed by the City to fund a portion of the benefit. This latter amount is the focus of this part of our discussion.

“(f) To ensure that all actuarial determinations necessary to safeguard the competency of public pension funds are made under the sole and exclusive direction of the responsible retirement boards.” [Emphasis added]

This Constitutional section and the statements of the voters’ intent in enacting it establish the essential mandates of a public retirement system board:

- To employ actuaries to determine the necessary funding of the retirement system;
- To act independently of political influence over those determinations; and
- To safeguard the “competency of the assets” of a public pension fund, that is, to ensure that the public pension system is adequately funded at all times.

2. Judicially Developed Rules

The actuarial rules related to funding public retirement plans in California have been the subject of considerable litigation. The following is a discussion of the basic principles established by the courts.

a. A Public Employee’s Contractual Right to an Actuarially Sound Plan

A public employee has two contractual rights with respect to his or her pension benefits: first, the employee has a right to the promised benefits; and, second, the employee has a right to an actuarially sound retirement system.

Respecting the first of these rights, Article I, Section 10, clause 1 of the United States Constitution and Article I, Section 9 of the California Constitution prohibit states from passing laws impairing the obligation of contracts. The courts have held that these constitutional provisions protect public employee pension benefits. For example, in Valdes v. Cory, supra, 139 Cal.App.3d 773, 783, the court said that “Under well-settled principles, these contract clauses limit the power of a state to modify its own contracts with other parties.” The Valdes court then went on to state:

““A public employee’s pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity.” Id. at 783-784 (citations omitted).

This same principle arises under local law as well. As the court stated in Abbot v. City of San Diego v. Agnew, supra, 165 Cal.App.2d 511 at 517:

“The pension provisions of a city charter are an indispensable part of the contract of employment between a city and its employees, creating a right to pension benefits as an integral part of compensation payable under such contract, which vests upon acceptance of employment.”

The court in Betts v. Board of Administration, 21 Cal.3d 859, 863-864 (1978) explained the basic doctrines governing public employee pension rights as follows:

“... An employee’s vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees’ pension rights must bear some material relation to the theory of a pension system and its successful operation, **and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.**” [Emphasis added]

See also Claypool v. Wilson, supra, 4 Cal.App.4th 646 at 661-662 which quotes extensively from the Betts decision.

As the highlighted language above indicates, the California Supreme Court in Betts recognized that modifications to public employee pension benefits could be made so long as any detriment is offset by an accompanying advantage.

Expanding on the concept of a contractual right to the promised benefits, the court in Board of Administration v. Wilson, supra, 52 Cal.App.4th 1109, held that state employees in the state Public Employees’ Retirement System (CalPERS) have a contractual right to an actuarially sound retirement system. Id. at 1137. (While this decision relates specifically to CalPERS, the holdings of the case have broader application to all public retirement systems in California.) In Board of Administration, CalPERS filed a petition for writ of mandate and complaint for declaratory relief, alleging that two statutory amendments (Senate Bills (SB) 1107 and SB 240) that changed the funding of CalPERS to an “in arrears” system under which contributions are not paid during same fiscal year that employee services are rendered, violated the contract clauses of the Federal and California State Constitutions. Id. at 1121-24.

The lower court ruled in favor of CalPERS, holding that “in arrears” financing was an unconstitutional impairment of contract. On appeal, the court of appeal affirmed the lower court’s ruling, holding that: (1) state employees under CalPERS had a contractual right to an actuarially sound retirement system; (2) the “in arrears” funding scheme

impaired this vested contractual right; and (3) therefore, the “in arrears” funding scheme was an unconstitutional impairment of contract. Id. at 1130-1154. Crucial to the court’s holding that SB 1107 and SB 240 impair vested contractual rights (Id. at 1144) was its conclusion that “state employees have a contractual right to an actuarially sound retirement system.” Id. at 1131. The court explained:

“under California law there is a strong preference for construing governmental pension laws as creating contractual rights for the payment of benefits, and when feasible to do so such laws should be construed as guaranteeing full payment to those entitled to its benefits ‘with the provision of adequate funds for that purpose.’” Id. (citation omitted); see, also, Valdes v. Cory, supra, 139 Cal.App.3d at 787.

In affirming the lower court’s ruling the Court of Appeal initially concluded: “Here, it is undisputed that Senate Bill No. 1107 and Senate Bill No. 240 were budget balancing measures. Appellant fails to show any pension reform or pension-related connection whatsoever” Id. at 1138. The court then addressed appellant’s contention that it was not required to assert any comparable new advantage because a comparable new advantage is required only in cases of modification of a pension benefit. Id. at 1145. The Court of Appeal rejected this argument stating that “the controlling principle applies to modification of any ‘vested contractual pension right.’” Id.; see, also, Valdes v. Cory, supra, 139 Cal.App.3d 773 at 784.

Based on a finding in the trial court that the Legislature had already appropriated the funds needed for making the contributions to CalPERS but had delayed the contributions on the basis of the change to “in arrears” funding, the Court of Appeal affirmed the lower court’s order that the shortfall amounts must be contributed immediately and that the State must return to quarterly funding in advance. While not entirely clear from the opinion, it appears that the courts would not have required the immediate funding of the shortfall had they not already been appropriated, based on the California Supreme Court’s ruling in Butt v. State of California, 4 Cal.^{4th} 668, 697-703 (1992).

These court decisions make it clear that employees covered by a public retirement system have two distinct contractual rights. The first is a right to the promised benefit. The second, and one that is of particular interest in the case of SDCERS, is the right to a retirement system that is funded on an actuarially sound basis. In subsequent discussion, we address the concept of actuarial soundness.

Although not a published decision, a recent case before the Ventura County Superior Court, Matthews v. Ventura County Employees’ Retirement Association, supra, Case No. CIV220607, is instructive as to the actuarial soundness of a public retirement system and the fiduciary duties of the board of administration. In a Tentative Statement of

Decision filed on December 13, 2005, the court held that the use of excess earnings by a public retirement system to reduce or completely offset the county's duty to make contributions to the system between 1998 and 2004 was not a violation of Article XVI, Section 17(b) of the California Constitution. Tentative Statement of Decision, pp. 2-3.

In Matthews, plaintiff sought a court determination that Ventura County Employees Retirement Association ("VCERA") mismanaged pension assets in such a way as to wrongfully excuse the County of Ventura ("County") from its obligation to make required employer contributions to the County's pension fund. Id. at pp. 1-2. More specifically, plaintiff contended that the administration of pension funds by VCERA violated Article XVI, Section 17(b) of the California Constitution by using "excess" earnings from the pension fund assets to offset and reduce the employer contributions of the county. Id. at p. 2. Plaintiff contended that VCERA should have used the excess earnings for the benefit of members of the pension system by retaining the earnings in a contingency reserve and/or using such earnings to provide supplemental health or cost of living benefits. Id. The court found in favor of VCERA, holding:

"the overriding mandate in Prop 162, when read as a whole, is to require VCERA to administer the pension funds in a sound actuarial manner so that the benefits promised to County employees during their work life will be paid in full and in a timely manner after they retire. Once such an actuarial goal is met, VCERA may still administer its funds to minimize the County's contribution." Id. at p. 11.

The court explained that the retirement system administered by VCERA was a defined benefit plan. Id. at p. 7. In a defined benefit plan, the employee is guaranteed to receive a specified benefit, and it is the employer that bears the burden of the investment risk. Id. The benefit that runs with the employer's risk is that the employer may reduce or eliminate its contribution for so long as the actuarial soundness of the fund justifies such action, i.e., is not adversely impacted. Id. On the other hand, an employer may have to pay increased contributions if needed to maintain the actuarial soundness of the fund. Id.

Citing the legislative history of Article XVI, §17 as amended by Proposition 162, the court also held that the board of administration has "sole and exclusive power to provide for actuarial services." Id. at p. 10. The court interpreted the board's duty to provide for actuarial services, as follows:

"The meaning is clear from the language used. As indicated in Singh v. Board of Retirement, supra, 41 Cal.App.4th 1180, and Westly v. Board of Administration, supra, 105 Cal.App.4th 1095, the purposes to be served in adopting the language fully support the plain meaning of 'sole and exclusive.' The actuarial services provided by a board of retirement with respect to using certain amortization

schedules cannot be subject to manipulation, directive, or control by the County.” Id.

The court found that VCERA met this standard. Specifically, the court found that:

- VCERA was at all relevant times at least 100% funded.
- VCERA’s “actuaries were competent, independent and only used accepted actuarial methodologies in determining when and how much, if any, the County was required to contribute to the retirement fund.” Id. at p. 10.
- The actuarial methods used by VCERA were within sound actuarial guidelines and followed generally accepted actuarial principles. Those methods included, but were not limited to, the counting of undistributed earnings as “valuation assets” and “actuarially smoothing” of its investment gains and losses over 5-year time periods .
- The VCERA retirement system had been managed in an actuarially sound manner.
- The Board’s decision-making process with respect to actuarial determinations, including, but not limited to, the setting of employer contributions rates, was deliberative and well informed. Those decisions were made and approved at public meetings, where members of the public could ask questions and make comments regarding the actuary’s assumptions, actuarial funding methods, asset valuation methods, actuarial cost methods and the County’s annual required contributions. Id. at p. 4.

Based on all of these factors, the court concluded that the short-term reduction or deferral of contributions by the county were permissible and that the board of administration had not violated its fiduciary or actuarial duties in approving those deferrals.

b. A Public Employee’s Constitutional Right to Actuarial Services Provided by a Retirement System Board

In addition to the right to promised benefits and an actuarially sound system, public employees have a constitutional right to have the funding of their retirement system determined actuarially and without interference from the political unit that created the system. This can be seen, for example, in Singh v. Board of Retirement, supra, 41 Cal.App.4th 1180, in which the Court of Appeal examined the effects of Proposition 162 (discussed above Part III.C.1; Proposition 162 amended Article XIV, §17 of the State Constitution). In particular, looking to Senate Publication No. 643-S, “Analysis of

November 1992 Ballot Propositions,” prepared by the California Senate Office of Research, the court analyzed the reasons the electorate adopted the “actuarial services” provision of Section 17(e) and gave the boards of retirement “sole and exclusive power to provide for actuarial services” pursuant to that provision:

“In the election on November 3, 1992, the voters of the state of California enacted Proposition 162, known as ‘The California Pension Protection Act of 1992.’ The enactment amended the second paragraph of section 17 of article XVI of the California Constitution to state: ‘Notwithstanding any other provisions of law or this Constitution to the contrary the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system, subject to ... the following:’

* * *

“Briefly, the proposition in question was in response to a bill which had permitted the Legislature and the Governor to use reserve funds in a retirement system (in this case, the state Public Employees’ Retirement System, or PERS) ‘to substitute for normal state payments required to fund the system-thereby freeing state money to help close the budget shortfall.’ (Analysis at p. 18.) (Assembly Bill No. 702 also transferred PERS actuarial functions to the Governor by giving him the power to appoint the PERS actuary.)

“The substitution of reserve account funds for state payments and the transfer of actuarial oversight powers away from PERS were ‘viewed by opponents as unwise and unfair, and many called it one more “raid” on the pension system.’ (Analysis at p. 18.) **Proposition 162 was thus intended by its proponents to insulate the administration of retirement systems from oversight and control by legislative and executive authorities, and also return control of the actuarial function to the retirement boards themselves. This ‘increased level of independence would make the [retirement] systems less of a target for local and state officials looking for a way to balance a budget.’** (Analysis at p. 20.)” Id. at 1183, 1191-1192. [Emphasis added]

More recently, in Westly v. Board of Administration, supra, 105 Cal.App.4th 1095, the court analyzed the ballot pamphlet for the November 3, 1992 General Election to determine the voters’ intent in giving boards of retirement “sole and exclusive power to provide for actuarial services”:

“The Legislative Analyst gives ... attention to the issue of a retirement board’s administrative authority under Article XVI, Section 17. It recognizes that prior to Article XVI, Section 17, the Constitution specified the general authority of the Board over public pension systems and that within these limits the Legislature

could change the administrative functions of public pension systems. Two examples which are given are legislation removing the actuarial function from the Board and placing it under a state actuary appointed by the Governor and confirmed by the Legislature, and legislation allowing the use of CalPERS assets to offset employer contribution costs.

“The analyst also states that Article XVI, Section 17 would give ‘the board of each public pension system complete authority for administration of the system’s assets and for the actuarial function.’ (Ballot Pamp., Gen. Elec., *supra*, Analysis by the Legislative Analyst, p. 37, italics added.)

“Thus, the voter intent, evidenced by the published ballot materials, is that Article XVI, section 17 would give the Board the authority to administer the investments, payments, and other services of CalPERS” *Id.* at 1111-1112.

Although the Westly case specifically involved CalPERS, the principles discussed in the decision apply equally to other public retirement systems in California.

Stated simply, these cases reflect the specific and unequivocal intent of the California Constitution, which is to give to the Board of Administration of a retirement system the authority, control and *responsibility* to make actuarial determinations regarding the funding of the system, without interference from the governmental unit whose employees are covered by the system. (As discussed in Part III of this Section, that goal was not met in the case of SDCERS.)

c. Analyzing Whether a Pension System is Actuarially Sound

The courts have taken up the issue of actuarial soundness in a number of cases. In Board of Administration v. Wilson, *supra*, 52 Cal.App.4th 1109, 1139, the court indicated that “the issue is not one of statutory construction but rather the factual question of the effect of deferred contributions on actuarial soundness of a retirement fund under actuarial, not legal, principles.”

In practice, the actuarial valuation of a fund is an ongoing endeavor, requiring complex assumptions regarding a number of variables, as well as regular corrections based on actual experience. *See, e.g., In re Retirement Cases*, (2003) 110 Cal.App.4th 426, 457-460. The In re Retirement Cases decision is instructive regarding the “ongoing” duties of the actuary of a public pension system. Citing Government Code §§31453⁷ and 31454⁸ of the County Employees Retirement Law of 1937 (CERL), the Court stated:

⁷ Government Code §31453 provides, in part:

“‘[a]ctuarial methodology is designed to address and consider unforeseen events on a regular basis so as to ensure the financial integrity of the retirement system.’ Indeed, CERL itself requires that each actuary for the retirement system conduct a formal actuarial valuation ‘within one year after the date on which any system ... becomes effective, and thereafter at intervals not to exceed three years.’ (§31453;)” *Id.* at 459 [Emphasis added]

The court here is pointing out three essential functions in determining actuarial soundness:

1. First, the actuary must take into account unforeseen events as part of the task of determining actuarial soundness. Stated another way, the actuary must not assume that current conditions will always prevail. As stated by the actuarial expert in *Board of Administration v. Wilson*, *supra*, “‘to determine the actuarial soundness of changes in the contribution pattern a **public** pension system requires the actuary to look to the long term **future** effects of those changes....”⁹ 52 Cal App 4th 1109,1141 [Emphasis in original]
2. Second, the analysis must be done on a regular basis (in this particular case, not less often than every three years). The purpose of this regular analysis is to take into account changing circumstances and apply them to the funding assumptions previously made and the current funding obligation of the public entity and, in employee contributory plans such as SDCERS, employee rates of contribution.

“An actuarial valuation shall be made within one year after the date on which any system established under this chapter becomes effective, and thereafter at intervals not to exceed three years. The valuation shall be conducted under the supervision of an actuary and shall cover the mortality, service, and compensation experience of the members and beneficiaries, and shall evaluate the assets and liabilities of the retirement fund.”

⁸ Government Code §31453 provides, in part:

“The board of supervisors shall, not later than 90 days after the beginning of the immediately succeeding fiscal year, adjust the rates of interest, the rates of contributions of members, and county and district appropriations in accordance with the recommendations of the board, but shall not fix them in amounts that reduce the individual benefits provided in this chapter.”

⁹ Interestingly, the actuarial expert making this statement on behalf of CalPERS was Richard Roeder, who was then the actuary for SDCERS.

3. Third, the purpose of the analysis is to ensure the financial integrity of the system.

The concept of “financial integrity” or actuarial soundness was described succinctly in 1992 by the court in Claypool v. Wilson, *supra*, where the court described the obligation of the CalPERS board as follows:

“At the outset the PERS Board was directed to make actuarial valuations of the fund and the liabilities of the system and to recommend to the Legislature appropriate changes in the rates of contribution **to achieve equality between valuation and liabilities.**” 4 Cal. App 4th at 653-654.

The Board of Administration v. Wilson case is also instructive. In that case, CalPERS filed a petition for writ of mandate and complaint for declaratory relief, alleging that two statutory amendments changing financing of CalPERS to an “in arrears” system under which contributions are not paid during same fiscal year that employee services are rendered (Senate Bill (SB) 1107 and SB 240) violated contract clauses of the Federal and California State Constitutions. *Id.* at 1121-1224. The lower court ruled that “in arrears” financing was an unconstitutional impairment of the state employees’ contractual right to an actuarially sound retirement system. *Id.* at 1122-1123. In affirming the lower court’s ruling the Court of Appeal rejected appellant’s contention that the legislation did not render the system actuarially unsound. *Id.* at 1138-1144.

The Court of Appeal explained that the question whether a particular fund is actuarially sound presents a factual question, rather than a statutory one. *Id.* at 1139. The court emphasized that whether CalPERS could meet its cash obligations currently was not the test that must be conducted by an actuary in evaluating the actuarial effects of the deferred contribution. *Id.* at 1141. Rather, to determine the actuarial soundness of changes in the contribution pattern, a public pension system requires the actuary to look to the long term future effects of those changes. *Id.*

The Court of Appeal also stressed that the most important general financial objective for any public retirement system is to practice intergenerational equity, which means calculating and receiving during each fiscal year contributions which, expressed as percents of active member payroll, will remain approximately level from the present generation of citizens to future generations of citizens. *Id.* at 1140. This level contribution system ensures that the benefit promises made to employees for services rendered would be paid as promised in the future when the employees retire. *Id.*

With these actuarial concepts in mind, the Court of Appeal based its determination that in arrears financing rendered PERS actuarially unsound primarily on the testimony of one the PERS actuarial experts. *Id.* at 1139-1144. The actuary explained that when contributions are delayed beyond the date assumed, the plan falls out of actuarial

balance and actuarial soundness is endangered. Id. at 1139. The accumulation of plan normal costs is called the plan's accrued actuarial liability. Id. at 1140. When the accrued actuarial liability exceeds the plan assets, an unfunded accrued actuarial liability exists. Id. Furthermore, the actuary explained, underpinning both the normal cost calculation and the amortization of the unfunded accrued actuarial liability is an explicit assumption concerning the timing of contributions. Id. The importance of timing stems from the fact that a large portion of a member's benefit is funded by the investment earnings which are generated by plan contributions. Id. When monies are contributed later than expected, reduced earnings result, thus creating a shortfall. Id. This impairs benefit security and causes a portion of the total current employment cost of plan members to be shifted into the future. Id. As to the in arrears system of the subject legislation, the PERS actuary concluded:

“Any delay in the payment of the employer contribution will result in a combination of a permanent shortfall in plan assets together with an increased annual contribution requirement. Delaying the payments for currently emerging liabilities places the responsibility of those liabilities onto a future generation of taxpayers....” Id. at 1143.

The Court of Appeal concluded that the delay in funding was not permissible and ordered that the State revert to the quarterly contribution schedule previously mandated by law and immediately make up the shortfall in funding.

These decisions help construe the governing provisions of the San Diego Municipal Code, which contains provisions similar to Government Code §§31453 and 31454 analyzed in the cases discussed above. Thus, San Diego Municipal Code §24.0901 states, in part:

“Each year, on a fiscal year established for this purpose, the Board will employ an Actuary to make a valuation of the System's assets and liabilities. At least once every five years, the Board will employ an Actuary to conduct a thorough investigation of the mortality, service and compensation experience of Members and other persons receiving benefits, along with an actuarial valuation of the System's assets and liabilities. From time to time, the Board will also determine the assumed rate of interest earnings for the Retirement Fund.”

Municipal Code §24.0901 states, in part:

“Based upon its investigations, valuations, determinations and the recommendation of the Actuary, the Board will adopt the mortality, service and other tables and interest rates it deems proper, and will revise the Members' contribution rates as it deems necessary, to provide the benefits of the Plan. The

Board's decisions on matters covered by this section are conclusive, if arrived at in good faith." [Emphasis added]

These provisions are, in substance, the same as those discussed in In re Retirement Cases, supra, where the court found that the obligation of a retirement system board was to ensure actuarial soundness. In light of this similarity, by analogy, this conclusion can be applied equally to SDCERS.

3. California Government Code Provisions

The California Government Code sets separate, specific guidelines for cities, counties and the state to establish a retirement system for its employees. The provisions regarding city retirement plans, Title IV, Division 5, Chapter 2 are found at Government Code §§45300-45317 (Article 1 – "General") and §45341-45345 (Article 2 – "Pension and Retirement Systems").

a. Relevant Government Code Provisions

Government Code §45342 mandates actuarial soundness for public pension systems. It states:

"Any pension or retirement system adopted **shall be on a sound actuarial basis** and provide for contributions by both the city and the employee members of the system which shall be based on percentages of payroll to be changed only by adjustments on account of experience under the system." [Emphasis added]

Government Code §45343 also addresses the required contributions to a public retirement system. The section provides:

"Contributions shall be in amounts which will accumulate at retirement a fund sufficient to carry out the promise to pay benefits to the individual on account of his service as a member of the system, without further contributions from any source."

Finally, Government Code §7504(a) provides the requirements for the proper actuarial funding of a public retirement system:

"All state and local public retirement systems shall, not less than triennially, secure the services of an enrolled actuary. An enrolled actuary, for the purposes of this section, means an actuary enrolled under subtitle C of Title III of the federal Employee Retirement Income Security Act of 1974 (Public Law 93-406) and who has demonstrated experience in public retirement systems. **The actuary shall perform a valuation of the system utilizing actuarial assumptions and**

techniques established by the agency that are, in the aggregate, reasonably related to the experience and the actuary's best estimate of anticipated experience under the system. Any differences between the actuarial assumptions and techniques used by the actuary that differ significantly from those established by the agency shall be disclosed in the actuary's report and the effect of the differences on the actuary's statement of costs and obligations shall be shown." [Emphasis added]

b. Applicability of Government Code Provisions

The Government Code provisions discussed in subpart a. are helpful in describing the actuarial basis for public retirement systems, but a threshold issue must first be addressed before applying them to SDCERS. Inasmuch as San Diego is a charter city, do these provisions apply to its municipal retirement plan? We have concluded that Government Code §§45342, 45343 and 7504(a), quoted above, do apply.

The general proposition that the municipal ordinances of a charter city govern the city's retirement system is well-stated in Charles Grimm v. City of San Diego, 94 Cal.App.3d 33 (1979), where the court said:

"San Diego is a charter city. It can make and enforce all ordinances and regulations regarding municipal affairs subject only to the restrictions and limitations imposed by the city charter, as well as conflicting provisions in the United States and California Constitutions and preemptive state law. Consequently, "[w]ithin its scope, such a charter is to a city what the state Constitution is to the state." (Citation omitted) 'Article XI, section 5, subdivision (b) of the California Constitution [gives] full power to charter cities to provide for the compensation of their employees. It is clear that provisions for pensions relate to compensation and are municipal affairs within the meaning of the Constitution.' (City of Downey v. Board of Administration (1975) 47 Cal.App.3d 621, 629 [121 Cal.Rptr. 295].) Id. at 37 [emphasis added].

The concept of overriding state law was addressed in City of Downey v. Board of Administration, 47 Cal.App.3d 621 (1975), in which the court explained:

"Article XI, section 5, subdivision (b) of the California Constitution does give full power to charter cities to provide for the compensation of their employees. It is clear that provisions for pensions relate to compensation and are municipal affairs within the meaning of the Constitution. It is also clear that a charter city has full control over its municipal affairs, and in respect to them is not subject to general law except as the charter may provide. **However, 'The municipal affairs doctrine does not foreclose state legislation with respect to municipal affairs of a home rule city; it is only in the event of a conflict between local and state**

regulations or state preemption of local regulation that the question whether the matter regulated is a municipal affair or of statewide concern becomes determinative.” *Id.* at 629 [citations omitted; emphasis added].

Jackson v. City of Los Angeles, 111 Cal.App.4th 899 (2003) set forth a similar rule: “Charter provisions, ordinances, or regulations “relating to matters which are purely ‘municipal affairs’” prevail over state laws covering the same subject.’ (Citation omitted)” *Id.* at 906. **“In matters of statewide concern**, however, applicable general state laws govern charter cities regardless of their charter provisions.” *Id.* [emphasis added].

The courts have concluded that, in general, the provisions of the Government Code do not apply to municipal retirement systems. For example, in Bellus v. City of Eureka, 69 Cal.2d 336 (1968), the court stated: “The State Pension Act by its own terms makes clear that its provisions are not intended to preempt the field of pensions for municipal employees [referring specifically to Government Code §45300 and 45301¹⁰].” *Id.* at 339, 346. Indeed, Government Code §45316 specifically provides that “This article provides an **alternative procedure** for the establishment of retirement systems in cities.” [Emphasis added]. And at least one court has stated that “Section 45316 makes it clear that the legislation was not of the pre-emptive nature claimed by the plaintiff” Grace v. City of Los Angeles, 249 Cal.App.2d 577, 584 (1967).

However, in addressing the sections of the Government Code dealing with actuarial issues (§§45342 and 45343, quoted above), the court in City of Costa Mesa v. McKenzie, 30 Cal.App.3d 763 (1973), emphasized that all city retirement plans must be maintained on a sound actuarial basis because of the preemptive effect of these provisions of the Government Code:

““The trial judge determined that sections 45300-45345 of the Government Code provided only an ‘alternative procedure’ for the establishment of a retirement system; that the disability plan provided by Ordinance No. 64-45 was not adopted under the Government Code sections; and that, therefore, it was not subject to section 45342’s requirement of actuarial soundness. Government Code section 45316 relied upon by the trial judge provides: ‘*This article* [art. 1 of tit. 4, div. 5 of the code] provides an alternative procedure for the establishment of retirement systems in cities.’ (Italics supplied.) **Government Code section 45342**,

¹⁰ Those sections provide: “It is the intent of this article to enable any city to adopt such a retirement system as is adaptable to its size and type.” Gov’t Code §45300. And: “By ordinance, any city may establish a retirement system for its officers and employees and provide for the payment of retirement allowances, pensions, disability payments, and death benefits, or any of them.” Gov’t Code §45301.

however, is in Article 2 of title 4, division 5 of the Government Code and provides that: '*Any pension or retirement system adopted shall be on a sound actuarial basis*' (Italics supplied.) Thus a municipal retirement plan whether enacted under Government Code sections 45300-45345 or pursuant to "an alternative procedure" must be on a sound actuarial basis. Under defendant's interpretation of Ordinance No. 64-45, Costa Mesa's retirement scheme might not be." *Id.* at 772-73 [Emphasis added except for indicated emphasis in original].

Supporting the conclusion set forth in *McKenzie*, the court in *Valdes v. Cory*, *supra*, 139 Cal.App.3d 773, specifically citing Government Code §45342, stated: "Cities electing to adopt their own retirement systems **must** do so on a 'sound actuarial basis' ([Government Code] § 45342.)" *Id.* at 781 n.4 [emphasis added]. Furthermore, emphasizing the preemptive effect of Government Code §§45342 and 45343, the Office of the Attorney General of the State of California stated as follows in Opinion No. 04-710 (October 4, 2005):

"Accordingly, charter cities enjoy 'autonomous rule over municipal affairs pursuant to Article XI, Section 5 of the California Constitution, "subject only to conflicting provisions in the federal and state Constitutions and to preemptive state law." [Citations.]'

* * *

"The Legislature has long provided for the establishment of retirement systems for city employees. (Gov. Code, §§ 45300-45345.) [Footnote omitted] A retirement system established by a city for the benefit of its employees is a 'public pension or retirement system' within the meaning of Article XVI of the Constitution. (See 86 Ops.Cal.Atty.Gen. 86, 88 (2003).)

"Once established, a public pension system operates essentially as a trust, to which current employee members and the pension plan sponsor (here, the city) make annual contributions. Contributions are made in amounts actuarially calculated to maintain the trust fund at a level sufficient to pay the benefits that have been promised to past and present employee members. [Government Code] Section 45342 provides:

"'Any pension or retirement system adopted shall be on a sound actuarial basis and provide for contributions by both the city and the employee members of the system which shall be based on percentages of payroll to be changed only by adjustments on account of experience under the system.

"'Contributions shall be in amounts which will accumulate at retirement a fund sufficient to carry out the promise to pay benefits to the individual on account of

his service as a member of the system, without further contributions from any source.”¹¹

Miscellaneous provisions regarding public retirement plans, generally (i.e., state, county and city retirement plans, collectively), are found at Government Code §§7500-7520 (Title 1, Division 7, Chapter 21). Like Government Code §§45342 and 45343, Government Code §7504(a), supra, contains mandatory language which would suggest that it is preemptive of municipal law with regard to pensions established by city charters.

4. Authority from City of San Diego

a. The City of San Diego City Charter

The City of San Diego City Charter, Article IX, Section 143, “Contributions,” provides in relevant part:

“The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, but shall not be required to contribute in excess of that amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past service of the employees. **The mortality, service, experience or other table calculated by the actuary and the valuation determined by him and approved by the board shall be conclusive and final, and any retirement system established under this article shall be based thereon.** Funding obligations of the City shall be determined by the Board on an annual basis and in no circumstances, except for court approved settlement agreements, shall the City and the Board enter into multi-year contracts or agreements delaying full funding of City obligations to the system. When setting and establishing amortization schedules for the funding of the unfunded accrued actuarial liability, the Board shall place the cost of the past service liability associated with a new retirement benefit increase on no greater than a fixed, straight-line, five year amortization schedule....” [Emphasis added]¹²

These sections of the City Charter contain a number of important elements that describe the duties of the Board of Administration, the funding and operation of SDCERS and the status of its funds:

¹¹ This paragraph is actually Government Code §45343, not §45342, as mistakenly indicated by the Attorney General’s Opinion.

¹² The third and fourth sentences quoted above were added by Proposition G, effective April 1, 2005.

- The mortality, service, experience and other factors used in determining the proper funding of the plan must be calculated by an actuary employed by the Retirement System.
- SDCERS must be “based on” the annual valuation determined by the actuary and approved by the Board. That is, the funding of the San Diego municipal retirement system must be based on actuarial determinations calculated by the SDCERS independent actuary and approved by the Board.
- The funding obligations of the City must be determined by the Board on an annual basis.
- There are limitations imposed on the time periods over which unfunded accrued actuarial liability and actuarial losses may be amortized.

In effect, this section recognizes the Constitutional mandates discussed in Part b.1. above that the Board must employ an actuary to determine the actuarial assumptions for the System and the valuation for the funding of the Retirement System and must act independently of political influence over those determinations. The second section of the quoted language, added by charter amendment adopted in 2004, addresses the final mandate that the retirement system be funded annually to ensure that it is adequately (i.e., fully) funded at all times.

b. San Diego Municipal Code

The relevant San Diego Municipal Code sections make clear that funding of SDCERS must be based on actuarial determinations. (Section references in this subpart are to the Municipal Code.) For example, Section 24.0901, “Rules, Actuarial Valuations, Determined Interest Assumption Rate, Employ Actuary, Investment Counsel,” requires the Board to employ an actuary to do annual valuations and to perform a “thorough investigation” of the experience elements that go into funding the system. That section provides in relevant part:

“The Board may make the rules it deems proper to administer the Retirement System....

“The Board may employ an actuary as needed. **Each year**, on a fiscal year established for this purpose, **the Board will employ an Actuary to make a valuation of the System’s assets and liabilities**. At least once every five years, the Board will employ an Actuary to conduct a thorough investigation of the mortality, service and compensation experience of Members and other persons receiving benefits, along with an actuarial valuation of the System’s assets and liabilities. From time to time, the Board will also determine the assumed rate of interest earnings for the Retirement Fund.” [Emphasis added]

Section 24.0902, "Adoption of Mortality, Service, Interest Rates and Other Tables," imposes on the Board the obligation to adopt mortality, service and other appropriate tables for funding the plan, based on the recommendation of the System actuary. The section states:

"Based upon its investigations, valuations, determinations **and the recommendation of the Actuary**, the Board will adopt the mortality, service and other tables and interest rates it deems proper, and will revise the Members' contribution rates as it deems necessary, to provide the benefits of the Plan. The Board's decisions on matters covered by this section are conclusive, if arrived at in good faith." [Emphasis added]

Section 24.1111 "City Contributions," requires that the City make contributions to SDCERS based on the annual actuarial valuation:

"The City shall contribute to the Retirement Fund a percentage of compensation earnable as determined by the System's Actuary pursuant **to the annual actuarial evaluation**. The required City contributions shall be determined separately by the Actuary for General Members and for Safety Members." [Emphasis added]

5. Actuarial Principles

For a discussion of Actuarial and Accounting Principles that apply to this Legal Analysis, *see* Sections IX and X of the Navigant Consulting Investigative Report.

D. "Plan Document" and IRS issues

1. Background

The San Diego City Employees' Retirement System (SDCERS) is a multiple employer governmental defined benefit pension plan (also referred to herein as the "Plan" or the "Pension Fund"), which is intended to be a "qualified plan"¹³ under Internal Revenue Code (the "Code") §§ 401(a) and 414(d).¹⁴ The current participating employers in SDCERS are the City of San Diego (the "City"), the Unified Port of San Diego (the "Port") and the San Diego County Regional Airport Authority (the "Airport").

SDCERS was originally established pursuant to the following documents:

¹³ A "qualified plan" is a plan that satisfies the requirements of § 401(a). Qualified plans include defined benefit pension plans, profit sharing plans, money purchase pension plans, § 401(k) plan, and stock bonus plans, including employee stock ownership plans. The term "qualified plan" also includes "governmental plans" under Code § 414(d).

¹⁴ Municipal Code § 24.1010, as amended by the proposed technical compliance ordinance.

- (i) the California State Constitution (the “Constitution”) Article XVI, Section 17;
- (i) the San Diego City Charter (the “City Charter”), Article IX, Sections 141 – 149;
- (iii) the San Diego Municipal Code (the “Municipal Code”) §§ 24.0100 – 24.1809, which are added, amended and repealed by Ordinances adopted by the San Diego City Council (the “City Council”);

As of May 20, 2005, the following additional documents had become part of the Plan:

- (iv) Annual Listing of Earnings Code Included In and Excluded from Retirement Base Compensation (“Earnings Code Document”);
- (v) City Council Resolution 297212, adopted 10/21/02;
- (vi) Article 15 of the Memorandum of Understanding between the City and the San Diego Municipal Employees’ Association effective July 1, 2002 through June 30, 2005;
- (vii) Article 47 of the Memorandum of Understanding between the City and International Association of Firefighters, Local 145 effective July 1, 2002 through June 30, 2005;
- (viii) Article 65 of the Memorandum of Understanding between the City and the San Diego Police Officers’ Association effective July 1, 2003 through June 30, 2005;
- (ix) (applicable solely to Airport employees) First Amended Agreement to Administer Retirement Plan between SDCERS and Airport dated September 17, 2004;
- (x) (applicable solely to Airport employees) First Amended Retirement Plan for Airport Authority Employees (“Airport Retirement Plan”);
- (xi) (applicable solely to Port employees) First Amended Agreement to Administer Retirement Plan between SDCERS and Port dated March 30, 2004; and
- (xii) (applicable solely to Port employees) Retirement Plan for San Diego Unified Port District Employees (“Port Retirement Plan”).¹⁵

Arguably, the SDCERS rules of the Retirement Board of Administration (the “Board rules”) and the SDCERS Board of Administration Trustee Handbook (the “Trustee Handbook”) have become, over time, part of Plan documentation. (The above-listed documents, including the Board rules and the Trustee Handbook, are collectively referred to herein as the “Plan Documents.”)

¹⁵ See May 20, 2005, Minutes of the SDCERS Board of Administration and Statement of Loraine E. Chapin, General Counsel, certifying that these documents constitute the documents of the Plan as of that date. See also Chapter 2 of the Board Rules.

The management and control of SDCERS is vested in the Board of Administration (the “Board”), which has authority to adopt rules and regulations it deems proper for the administration of SDCERS. *See* Cal. Const. Article XVI, Section 17, City Charter Sections 141-149, Municipal Code §§ 24.0100-24.1809 and Board Rules 1.10, 1.40 – 1.44. The Board may establish rules and procedures for eligibility, participation and coverage relative to the provision of retirement, health and disability benefits. The Board may also secure and pay reasonable compensation for the medical services and advice it deems necessary to discharge its duties. *See* Municipal Code § 24.0901. *See* also City Charter Article IX, Section 144. In summary, the Board is at times the sole judge of the conditions under which persons may receive benefits from SDCERS, and is responsible for insuring that those benefits are properly funded and paid. *See* City Charter Article IX, Section 144. Finally, the Board retains plenary authority and fiduciary responsibility for investment of moneys and administration of SDCERS, as provided for in Article XVI of the Constitution, Section 17.¹⁶

Beginning in 1996, the City entered into an agreement with the Board to stabilize the City’s contribution rate to the Pension Fund. This agreement was identified as Manager’s Proposal 1. Effective November 18, 2002, the City and the Board entered into another agreement, known as Manager’s Proposal 2, under which the City increased its annual contribution rate to pay for increased benefits. In between Manager’s Proposals 1 and 2, the City settled a class-action lawsuit over Pension Fund benefits. This case is referred to herein as Corbett. There are two Pension Fund benefit programs that will be discussed in this section. One is the Presidential Leave Benefit program and the other is the retiree healthcare program. As a part of implementing the retiree healthcare program, SDCERS and the City established a separate trust account within the pension fund. All SDCERS, City, Port and Airport retiree healthcare premiums are paid from this separate account, which was later formally named the “401(h) Fund.” The total cost of retiree healthcare is purportedly funded through current or reserved excess earnings of the pension fund, which are transferred to and paid out of the 401(h) Fund. *See* Municipal Code §§24.1203(b) and 24.1204, 24.1502(a)(5); Trustee Handbook, page 56.

2. Applicable Law – Generally

Code § 401(a) requires that a qualified retirement plan be operated for the “exclusive benefit” of the plan’s participants and their beneficiaries. Specifically, § 401(a) provides as follows:

REQUIREMENTS FOR QUALIFICATION. — A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing of an

¹⁶ Constitution Article XVI, Section 17, provides that “the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of SDCERS.” *See* also City Charter Article IX, Section 143.

employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

The exclusive benefit rule as it relates to pension plans is explained in Treasury Regulations (“Treas. Reg.”) § 401-1(b)(1)(i), which states in relevant part as follows:

General Rules.— (1)(i) A pension plan within the meaning of § 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees....A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of § 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses described in § 401(h) as defined in paragraph (a) of §1.401-14). (Emphasis Added).

The exclusive benefit rule is also provided for in both the Constitution and the City Charter. Specifically, Article XVI, § 17(a) of the Constitution provides as follows:

The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. **The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.** [Emphasis added]

In addition, Article XVI, § 17(b) of the Constitution states as follows:

The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their

beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system.

Finally, the exclusive benefit rule is provided for in the City Charter. Article IX, § 145 of the City Charter states as follows:

All moneys contributed by employees of the City or appropriated by the Council or received from any other source under the terms of this Articles, shall be placed in a special fund in the City Treasury to be known as the City Employees' Retirement Fund, which said fund is hereby created. Such fund shall be a Trust Fund to be held and used only for the purpose of carrying out the provisions of this Article. No payments shall be made therefrom except upon the order of the Board of Administration. This fund may be placed by the Board under the Funds Commission for investment; but shall not be merged with other funds of the City.

Notwithstanding the exclusive benefit rule described in Code, related regulations, the Constitution and the City Charter, the regulations and Code § 401(h) contain an exception which permits a pension plan to provide for the payment of benefits for medical expenses of retired employees, their spouses and their dependents. This exception to the exclusive benefit rule, as well as the SDCERS 401(h) program, are specifically provided for under the Plan Documents. The relevant laws and Plan Documents are discussed under the section entitled "Retiree Healthcare Program and Code § 401(h) Compliance," below.

In addition to the exclusive benefit rule, qualified plans must operate in strict accordance with their written terms. Specifically, Treas. Regs. § 1.401-1(a)(1) and (2) provide as follows:

(a) Introduction. (1) Sections 401 through 405 relate to pension, profit-sharing, stock bonus, and annuity plans, compensation paid under a deferred-payment plan, and bond purchase plans. Section 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

(2) A qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer—

The Board Rules also acknowledge or otherwise take into account the legal obligation to operate the Pension Fund pursuant to the Plan Documents and, thus, a definite written program. Rule 1.00 states that "[t]hese rules are established under § 144 of the Charter of the City of San Diego . . . [t]hese Rules augment the retirement ordinances of the City

of San Diego, as contained in the San Diego Municipal Code . . . [t]hese Board Rules are subordinate to the City Charter. They are also subordinate to the Municipal Code . . . the Board [may not] violate any terms of the Constitution, the City Charter, the Municipal Code . . .” In addition to the Board Rules, the Trustee Handbook requires the Pension Fund to be operated pursuant to terms of the Plan Documents. Specifically, the Trustee Handbook states that the Board is to administer the Plan by “adopting regulations and procedures . . .” The Trustee Handbook then goes on to list the City Charter (Articles IX and X) and the Municipal Code, Chapter 2, Article 4, as part of the documents that comprise the “Plan Documents.” Finally, the Constitution contemplates the “definite written program” by providing the Board with the authority to satisfy it. Specifically, in Article XVI, § 17(a) of the Constitution it states that “[t]he retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries.”

Under the IRS’ Employee Plans Compliance Resolution System (“EPCRS”), which is the consolidation of the IRS’ correction programs for qualified plans, the IRS highlights the definite written program requirement. EPCRS is currently set forth in Revenue Procedure (“Rev. Proc.”) 2003-44, 2003-23 IRB 1051, and § 1.02 thereof addresses the purpose and general correction principals underlying EPCRS. That section states that “Sponsors and other administrators should make voluntary and timely correction of any plan failures [in] . . . plan operations [so as to protect] . . . participating employees by providing them with their expected retirement benefits, including favorable tax treatment.” EPCRS describes defects that adversely affect a plan’s tax-favored status as “Qualification Failures.” Qualification Failures include “Operational Failures,” which are failures to follow the terms of the plan documents. Section 5.01(2)(b) of Rev. Proc. 2003-44 defines the term Operational Failure as follows:

Operational Failure. The term “Operational Failure” means a Qualification Failure (other than an Employer Eligibility Failure) that arises solely from the failure to follow plan provisions. A failure to follow the terms of the plan providing for the satisfaction of the requirements of § 401(k) and § 401(m) is considered to be an Operational Failure. A plan does not have an Operational Failure to the extent the plan is permitted to be amended retroactively pursuant to § 401(b) or another statutory provision to reflect the plan’s operations. However, if within an applicable remedial amendment period under § 401(b), a plan has been properly amended for statutory or regulatory changes and, on or after the later of the date the amendment is effective or is adopted, the amended provisions are not followed, then the plan is considered to have an Operational Failure.

Any Operational Failure that causes a plan participant to receive a benefit which is larger than the benefit he or she is entitled to under the terms of the plan, results in an

excess benefit, which is referred to by the IRS as an “overpayment.” Section 5.01(6) of Rev. Proc. 2003-44 defines an overpayment as follows:

The term “Overpayment” means a distribution to an employee or beneficiary that exceeds the employee’s or beneficiary’s benefit under the terms of the plan, including a distribution that results from a failure to comply with plan terms that implement § 401(a)(17), §401(m) (but only with respect to the forfeiture of nonvested matching contributions that are excess aggregate contributions), § 411(a)(3)(G), or § 415. An Overpayment does not include a distribution of any Excess Amount described in § 5.01(3)(b) through (h).

Overpayments can subject a tax-qualified plan to disqualification by the IRS.

3. Applicable Law – 401(h) Accounts

Treas. Regs. § 1.401-1(b)(1)(i) states the general rule that the assets of a tax-qualified pension plan can be used only to provide for traditional retirement benefits. Specifically, a pension plan fails to satisfy the tax-qualification rules under the Code if its assets are used to provide “for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in § 401(h), as defined in paragraph (a) of § 1.401-14).” Thus, notwithstanding the exclusive benefit rule described in Code § 401(a) and related regulations, there is an exception under Code § 401(h) that permits the pension plan to provide for the payment of benefits for medical expenses of retired employees, their spouses and their dependants, but only if the provisions of Code § 401(h) are strictly adhered to. Code § 401(h) provides, in relevant part, as follows:

(h) MEDICAL, ETC., BENEFITS FOR RETIRED EMPLOYEES AND THEIR SPOUSES AND DEPENDENTS. — Under regulations prescribed by the Secretary, and subject to the provisions of section 420, a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents but only if—

- (1) such benefits are subordinate to the retirement benefits provided by the plan,
- (2) a separate account is established and maintained for such benefits,
- (3) the employer’s contributions to such separate account are reasonable and ascertainable,
- (4) it is impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus

or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits,

- (5) notwithstanding the provisions of subsection (a)(2), upon the satisfaction of all liabilities under the plan to provide such benefits, any amount remaining in such separate account must, under the terms of the plan, be returned to the employer, and
- (6) in the case of an employee who is a key employee, a separate account is established and maintained for such benefits payable to such employee (and his spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are only payable to such employee (and his spouse and dependents) from such separate account. . .

As indicated above, a key requirement in Code § 401(h)(1) compliance is that the retiree medical benefits be subordinate to the retirement benefits provided by the plan.” Treas. Reg. 1.401-14(c)(1) explains this requirement as follows:

The plan must specify the medical benefits described in section 401(h) which will be available and must contain provisions for determining the amount which will be paid. Such benefits, when added to any life insurance protection provided for under the plan, must be subordinate to the retirement benefits provided by such plan. For purposes of this section, life insurance protection includes any benefit paid under the plan on behalf of an employee-participant as a result of the employee-participant's death to the extent such payment exceeds the amount of the reserve to provide the retirement benefits for the employee-participant existing at his death. The medical benefits described in section 401(h) are considered subordinate to the retirement benefits if at all times the aggregate of contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions (made after such date) other than contributions to fund past service credits. (Emphasis Added).

In addition to requiring that the medical benefits be subordinate to the plan's retirement benefits, Code § 401(h)(2) requires that the plan sponsor establish and maintain a separate account from which the medical benefits are to be paid. Specifically, Treas. Reg. 1.401-14(c)(2) states as follows:

Where medical benefits described in section 401(h) are provided for under a qualified pension or annuity plan, a separate account must be maintained with respect to contributions to fund such benefits. The separation required by this section is for recordkeeping purposes only. Consequently, the funds in the

medical benefits account need not be separately invested. They may be invested with funds set aside for retirement purposes without identification of which investment properties are allocable to each account. However, where the investment properties are not allocated to each account, the earnings on such properties must be allocated to each account in a reasonable manner. (Emphasis Added).

With respect to this separateness requirement, the IRS has explained that “it is clear from the specific limitations and restriction set forth in the Code and regulations that medical benefits described in Code § 401(h) are considered to be liabilities of a distinctly different nature than pension liabilities under a qualified plan and that plan assets held under 401(h) medical benefits accounts are considered as distinctly different entities from other assets providing funding for retirement benefits. These distinctions clearly indicate that the intent of the regulations was to maintain 401(h) benefit accounts entirely as separate entities within a qualified pension plan.” From this the IRS concluded that “a plan will not qualify under §§ 401(a) and (h) of the Code, if excess assets under a qualified pension or annuity plan may be allocated to a medical benefits account under the Plan.” There is, however, an exception for qualified transfers, as described below.

Code § 401(h)(3) also requires that the employer's contributions to the separate account be “reasonable and ascertainable.” This concept is discussed in Treas. Reg. 1.401-14(c)(3) as follows:

Section 401(h) further requires that amounts contributed to fund medical benefits therein described must be reasonable and ascertainable. For the rules relating to the deduction of such contributions, see paragraph (f) of section 1.404(a)-3. The employer must, at the time he makes a contribution, designate that portion of such contribution allocable to the funding of medical benefits.

The “reasonable and ascertainable” requirement is further explained in Private Letter Ruling 9834037, which states that “[t]he contributions for medical benefits provided by the § 401(h) must be reasonable and ascertainable, and the plan must contain provisions for determining the amount which will be paid. These requirements will not be satisfied unless the terms of the plan specify the amounts of benefits and the time period with respect to which benefits will be paid.”

Finally, Code § 401(h)(4) provides that it must be “impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits.” This “exclusive benefit” requirement is further explained in Treas. Reg. 1.401-14(c)(4) as follows:

Section 401(h) further requires that it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide for the payment of medical benefits described in section 401(h), for any part of the corpus or income of the medical benefits account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits. Consequently, a plan which, for example, under its terms, permits funds in the medical benefits account to be used for any retirement benefit provided under the plan does not satisfy the requirements of section 401(h) and will not qualify under section 401(a). However, the payment of any necessary or appropriate expenses attributable to the administration of the medical benefits account does not affect the qualification of the plan.

As an exception to the general rule that “a plan will not qualify under §§ 401(a) and (h) of the Code, if excess assets under a qualified pension or annuity plan may be allocated to a medical benefits account under the Plan,” Code § 420 permits a defined benefit plan to transfer “excess amounts” from the pension trust to the § 401(h) account for purposes of paying retiree medical benefits. Such a transfer, if done properly pursuant to a “qualifying transfer,” will not adversely affect a plan’s tax-qualified status or constitute a prohibited transaction under Code § 4975. Specifically, Code § 420(a) provides as follows:

If there is a qualified transfer of any excess pension assets of a defined benefit plan (other than a multiemployer plan) to a health benefits account which is part of such plan — (Emphasis Added).

- (a)(1) a trust which is part of such plan shall not be treated as failing to meet the requirements of subsection (a) or (h) of section 401 solely by reason of such transfer (or any other action authorized under this section),
- (2) no amount shall be includible in the gross income of the employer maintaining the plan solely by reason of such transfer,
- (3) such transfer shall not be treated — (A) as an employer reversion for purposes of section 4980, or (B) as a prohibited transaction for purposes of section 4975, and
- (4) the limitations of subsection (d) shall apply to such employer.

Code § 420(e)(2) defines excess pension assets as follows:

- (2) Excess Pension Assets. — The term “excess pension assets” means the excess (if any) of —
 - (A) the amount determined under section 412(c)(7)(A)(ii), over
 - (B) the greater of —

- (i) the amount determined under section 412(c)(7)(A)(i), or
- (ii) 125 percent of current liability (as defined in section 412(c)(7)(B)).

The determination under this paragraph shall be made as of the most recent valuation date of the plan preceding the qualified transfer.

Thus, pursuant to Code § 420(e)(2), “excess pension assets” must be actuarially determined.

Finally, Code § 420(b)(3) states that “[t]he amount of excess pension assets which may be transferred in a qualified transfer shall not exceed the amount which is reasonably estimated to be the amount the employer maintaining the plan will pay (whether directly or through reimbursement) out of such account during the taxable year of the transfer for qualified current retiree health liabilities.”

Regarding the amount available for transfer from a pension plan’s general assets to a Code § 401(h) account, Private Letter Ruling 200315038 states that “a governmental plan in order to comply with the requirements of § 420 of the Code must determine the amount of available excess assets available for transfer in accordance with § 420(e)(2) of the Code, and therefore must make the determinations provided for in §§ 412(c)(7)(A)(i), 412(c)(7)(A)(i) and 412(c)(7)(B) of the Code, notwithstanding the general exclusion of governmental plans from § 412.” Regarding the adequacy of pension plan funding in order to be eligible to make a transfer of assets to a 401(h) account, the Court in Chemtech Industries, Inc. v. Goldman Financial Group, Inc., 809 F.Supp. 729 (E.D.Mo. 1994) stated that

“[t]he appropriate test for determining adequacy of funding after a § 420 transfer is whether there are sufficient funds remaining in the plan to cover current liability, the obligation to fund the benefits of the participants as they come due. This standard takes into account the fact that the plan will continue as an on-going plan and not be terminated in the near future. This is the standard set forth in 26 U.S.C. § 412 and specifically incorporated into § 420.”

4. Applicable Law – Prohibited Transaction Issue

A tax-exempt organization will lose its exempt status if it engages in a “prohibited transaction.” Section 501(a) provides as follows:

“(a) Exemption from taxation

An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.”

Code § 503(b) describes a prohibited transaction as follows:

“(b) Prohibited Transactions

For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section--

- (1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;
- (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
- (3) makes any part of its services available on a preferential basis to;
- (4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;
- (5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or
- (6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c)(4)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.”

The prohibited transaction rules are further explained in Treas. Regs. § 1.503(b)- 1(a) as follows:

“The term prohibited transaction means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of § 1.503(a)-1. Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization; (3) a member of the family (as defined in section 267(c)(4)) of an individual who is such creator of or such

substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503(b), by such creator or substantial contributor.”

With respect to the ramifications of committing a prohibited transaction, Code §503(a) states as follows:

(a) Denial of exemption to organizations engaged in prohibited transactions

“(1) General rule

(A) An organization described in section 501(c)(17) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after December 31, 1959.

(B) An organization described in section 401(a) which is referred to in section 4975(g) (2) or (3) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after March 1, 1954.”

Code § 4975(g) makes it clear that tax-qualified government retirement plan are subject to the prohibited transaction rules of Code §503(a) and (b). Specifically, Code § 4975 states as follows:

“(g) Application of section

This section shall not apply -

(1) in the case of a plan to which a guaranteed benefit policy (as defined in section 401(b)(2)(B) of the Employee Retirement Income Security Act of 1974) is issued, to any assets of the insurance company, insurance service, or insurance organization merely because of its issuance of such policy;

(2) to a governmental plan (within the meaning of section 414(d)).”

IV. DISCUSSION OF SPECIFIC FINDINGS AND ISSUES

A. Manager’s Proposal 1

1. Summary of Conclusions

Based on the evidence developed by Navigant Consulting and discussed in earlier Sections of this Report, we have concluded that the Board acted improperly in approving MP 1. To the extent MP 1 permitted the City to fund the Retirement System on a basis that was not actuarially based, it violated state and municipal law and was a breach of fiduciary duty by the Board.

The discussion that follows addresses only the funding aspects of MP 1 and the fiduciary and actuarial issues related thereto.¹⁷ We have not assessed and have not drawn any legal conclusions with respect to increases in benefits to City employees that occurred in conjunction with MP 1 for two reasons. First, that is an issue that must be investigated and evaluated taking into account City activities and motivations. Second, it will require the resolution of conflict of interest issues currently being litigated in the civil and criminal courts. Thus, the comments that follow regarding the impropriety of MP 1 should be read in this context. To emphasize this point, we refer to the arrangement as “MP 1 Funding” when discussing the Board’s activities related to their fiduciary duties and the funding issues.

In its Summary of Findings and Conclusions, Navigant Consulting makes the following statements (among others) [Navigant Consulting findings, Section IV; hereafter, references to Sections appearing in brackets are to the Navigant Consulting discussion]:

1. The City contributed less than the Actuarially Required Contribution resulting in the underfunding of SDCERS since at least as early as 1996. The City has not made up for contribution shortfalls from previous years.
2. MP1 and MP2 did not make economic or actuarial sense because the agreements decreased the City’s contribution to SDCERS at the same time as the City granted benefit improvements to City employees.
3. The SDCERS’ Board approved MP1 and MP2 dispute concerns raised by Board members, the Board’s fiduciary counsel and the System’s actuary.
4. The annual actuarial valuations prepared for SDCERS contained misleading statements about the funding objectives and practices.
5. The SDCERS’ fiduciary counsel and actuary could have more clearly explained their concerns to the Board and could have been more forthcoming in stating a position with regard to both MP1 and MP2.

Based on these Findings and Conclusions and other evidence presented by Navigant Consulting in its Investigative Report, we have reached certain legal conclusions. The following is a summary of those legal conclusions. As noted in the Introduction to this Legal Analysis Section of the Report, we have relied on the investigation, findings, conclusions and evidence developed by Navigant Consulting without any independent

¹⁷ Much of the information appearing in this part duplicates material appearing in the discussion of MP 2. We believe this is necessary for two reasons: first, we believe each analysis should stand on its own; second, the similarities between the two situations require a discussion of much of the same material.

verification on our part. Based on those items, we believe that, if this matter were litigated, the substantial weight of the evidence would lead a court to conclude:

- MP 1 Funding failed to assure the “competency” of the Retirement System assets as required by the state Constitution.
- MP 1 Funding violated the contract clauses of the state and federal Constitutions by permitting SDCERS to be significantly under funded.
- MP 1 Funding violated the state Constitution’s restriction on political interference in the administration and funding of SDCERS.
- The Board of Administration breached its duty to follow the law with respect to the funding of the Retirement System and in the process violated the State Constitution, the Government Code, the City Charter and the Municipal Code.
- The Board of Administration violated its fiduciary duty to the Members of SDCERS by failing to act prudently for the exclusive purpose of providing an adequately funded plan for the Members. In particular, the Board failed to:
 - Conduct a proper investigation of the relevant facts;
 - Failed to adequately supervise and monitor the SDCERS staff and the experts they engaged to assist them in assessing MP 1 to ensure that they were developing and presenting to the Board the proper information on which to make an informed and reasoned decision;
 - Failed to make an informed and reasoned decision.
- The Board of Administration again breached its duties not to engage in activities beyond the scope of its responsibilities and to avoid participating in activities that violate the enunciated intent of Prop. 162 by entering into a contract that coupled increases in benefits with reductions in funding. The determination of the benefits payable to the Members of SDCERS is properly made only by the City Council, and the Board should not have participated in that determination.
- To the extent an underfunding exists as a result of the MP 1 Funding and MP 2 Funding arrangements that were not corrected in connection with the Gleason settlement, the Board is obligated to collect from the City of the difference between the contributions actually made and those that should have been made had SDCERS been funded on an actuarially sound basis, plus lost earnings on those contributions. The Board should consult with its actuary and legal counsel to determine the proper timing of the owed amount and should request that the City pay the unpaid balance accordingly.

2. Discussion of Actuarial Issues

a. Actuarial Requirements

In assessing the actuarial requirements imposed on the Board, it is appropriate to review the legal requirements and principles discussed above in Part III.C. These fall into the following six categories:

(1) California Constitution: The Board has the obligation to provide for actuarial services in order to assure the competency of the assets of the Retirement System.¹⁸ For these purposes, “competency” means adequacy or actuarially soundness. Further, one of the principle purposes of the 1992 revisions to Article XVI, Section 17 of the Constitution was to assure that public retirement systems would remain free from political interference.

(2) Case Law: Members of a retirement system have a contractual right under the contract clauses of the state and federal Constitutions to an actuarially sound pension fund. This means calculating the contributions based on actuarial valuations of the assets and liabilities of the retirement system, using established actuarial principles. [See Part III.C.2 above] These principles are discussed further below.

(3) Government Code: Applicable state law requires that a public retirement system be maintained on an actuarially sound basis and that contributions be in amounts that will accumulate a retirement fund sufficient to carry out the promise to pay benefits without further contributions. As stated by the Attorney General in a recent opinion commenting on the Government Code provisions related to funding:

“Contributions [to a public retirement system must be] made in amounts actuarially calculated to maintain the trust fund **at a level sufficient to pay the benefits that have been promised to past and present employee members.**” October 4, 2005 AG Opinion No. 04-710 (October 4, 2005). [Emphasis added]

(4) City Charter: Section 143 of the Charter imposes several distinct requirements with respect to the actuarial determination of funding of the Retirement System:

- The actuary must determine the mortality, service, experience or other tables to be used in funding the Retirement System.
- The actuary must determine the valuation of the Retirement System.

¹⁸ The Constitution imposes on the board of a public retirement system the “sole and exclusive responsibility” for administering the Retirement System to “assure prompt delivery of benefits” and the “sole and exclusive power to provide for actuarial services in order to assure the competency of the assets....” [Emphasis added] Read together, we conclude that the responsibility to provide benefits and the power to provide for actuarial services creates an obligation on a retirement system board to employ actuarial services to assure the competency of the assets.

- The Board must approve the calculations and determinations made by the actuary.
- The Retirement System must be based on the mortality, service, experience or other tables calculated by the actuary and the valuation determined by the actuary, as approved by the Board.

(5) Municipal Code: The Municipal Code imposes additional requirements on the Board with respect to funding:

- The Board is required to engage an actuary and to have the actuary perform a valuation of the assets and liabilities of the System each year.
- At least once every five years, the Board must have an actuary to conduct a thorough investigation of the mortality, service and compensation experience of Members.
- Based upon its own investigations, valuations and determinations and the recommendations of the actuary engaged by the Board, the Board must adopt the mortality, service and other tables and interest rates it deems proper for the funding of the Retirement System.

(6) Actuarial Principles: A key actuarial principle is the concept of an actuarially sound plan. As stated in Section IX.D., Actuarial Soundness, of the Navigant Consulting Investigative Report, actuarial soundness may be defined as follows:

“The financial objective of the pension plan shall be to establish and receive contributions which will remain approximately level from year to year and will not have to be increased for future generations of citizens. This objective is achieved when contributions received each year by the pension fund are sufficient both, (1) to fully cover the costs of benefit commitments being made to employees for their service being rendered in such year and, (2) to make a level payment which, if paid annually over a reasonable period of future years, will fully cover the unfunded costs of benefit commitments for service previously rendered.”

The elements of actuarial soundness under this definition are the following:

- Contributions should be level from year to year and not transfer the liability for funding benefits of current Members on future generations.
- Contributions received each year should be sufficient to fully cover the costs of benefit commitments being made to Members for the current year’s service.

- Contributions received each year should also be sufficient to make a level payment that will fully amortize unfunded costs for benefits related to previously rendered services.

The Government Code provision requiring that “Contributions be in amounts which will accumulate at retirement a fund sufficient to carry out the promise to pay benefits to the individual on account of his service as a member of the system, without further contributions from any source” is consistent with the foregoing definition.

Further, as reflected in Section IX.D. of the Investigative Report, “achieving a balance between benefit security and funding stability is a delicate task. It requires ongoing ‘financial engineering’---diligence in monitoring a plan’s fiscal health and making course corrections in a timely and planned manner.” This suggests that contributions levels should not be approved on a multi-year basis but should be reassessed on an ongoing basis to ensure that the retirement system remains actuarially sound. This is borne out by the GASB rules described in Section X.A., Authoritative Accounting Literature, which indicates that “the actuarial valuation should occur yearly (unless the plan calls for a biannual valuation)...[and] [t]he actuarial valuation should include all pension benefits covered by the plan terms at the valuation date.”

We understand that there may be a variety of possible definitions of “actuarial soundness.” Nevertheless, in light of the Government Code provision quoted above and the other provisions of California law related to actuarial funding of public retirement systems, we believe that the better reasoned view and the one that would be accepted by the California courts (and one that makes common sense) is that the benefit liabilities and the system’s assets would approximate one another in value. As a result, for purposes of the legal analysis that follows, in applying the term “actuarial soundness” we use that definition.

b. Analysis of Actuarial Requirements

As reflected in the Findings and Conclusions developed by Navigant Consulting, the result of MP 1 Funding was a retirement system that was not actuarially based and that would ultimately become under funded.¹⁹ Based on the discussion of actuarial principles contained in Section IX, Actuarial Analysis, of this Report and the definition of actuarial soundness stated above, we believe this resulted in an actuarially unsound

¹⁹ During the first few years after MP 1 Funding was approved, strong investment earnings largely offset the effects of the reduced contributions by the City. It appears that the City and the Board assumed that strong investment earnings would continue indefinitely into the future and would always be available to permit the City to make contributions that were not actuarially based.

retirement system. Further, the funding proposal contained in MP 1 was not actuarially based. As a result, MP 1 Funding did not satisfy any of the six criteria listed above and, therefore, violated the funding provisions of the State Constitution, the Government Code, the City Charter and the Municipal Code.

While all of the six criteria were violated by the Board's approval of MP 1 Funding, the violation of any one of them would have been a breach of the Board's duties.

i. Actuarial Soundness

In reaching these conclusions, we start with an assessment of whether SDCERS met the elements of an actuarially sound plan after the approval of MP 1 Funding.

- Contributions should be level from year to year and not transfer the liability for funding benefits of current Members on future generations. Based on Navigant Consulting's findings, we believe this requirement was not met. [See Navigant Consulting Conclusion 1, above]
- Contributions received each year should be sufficient to fully cover the costs of benefit commitments being made to Members for the current year's service. Based on Navigant Consulting's findings, we believe this requirement was not met. [See Navigant Consulting Conclusion 1, above]
- Contributions received each year should also be sufficient to make a level payment that will fully amortize unfunded costs for benefits related to previously rendered services. Based on Navigant Consulting's findings, we believe that this was not true. [See Navigant Consulting Conclusion 1, above]

ii. Failure to Comply with Legal Requirements

We now look to each of the legal requirements separately. While we have determined that the board failed to comply with all six of the indicated requirements, we note that non-compliance with any one of them in approving the MP 2 Funding would have been a violation of law by the Board.

- The Constitutional Requirement: Based on the Navigant Consulting findings, we conclude that the Board failed to assure the "competency" of the assets of SDCERS by failing to maintain the actuarial soundness of the Retirement System (as described above) [See Navigant Consulting Conclusion 1, above] *See also* the discussion of the Government Code below for additional analysis of the actuarial soundness issue.

- The Case Law: Because the effect of MP 1 Funding was that SDCERS would not be actuarially sound (as described above and for the reasons set forth under the discussion of the Government Code below), MP 1 Funding violated the contract clauses of both the state and federal Constitutions.
- The Government Code: The level of contributions approved in MP 1 Funding were not in amounts that would accumulate a retirement fund sufficient to carry out the promise to pay benefits without further contributions in the future and, further, were not actuarially calculated nor established at a level that would maintain the trust fund at a level sufficient to pay the benefits to past and current Members. Indeed, it appears that the funding levels agreed to under MP 1 Funding, after taking into account the benefit increases agreed to by the City at the same time, were not sufficient to cover the normal cost of the retirement system each year, much less amortize a portion of the unfunded liability.
- The City Charter: MP 1 Funding permitted funding that was not determined by the actuary and contributions that were not based on actuarial tables or other calculations made by the actuary, both as required by Section 143. Therefore, the Board violated the Charter in approving MP 1 Funding.²⁰
- The Municipal Code: MP 1 Funding did not provide for funding that was based the recommendations of the actuary or on the Board's own investigations, valuations and determinations made in reliance on those recommendations. Thus, MP 1 Funding violated the Municipal Code provisions related to funding.
- Actuarial Principles: MP 1 Funding did not comply with sound actuarial principles. It did not provide for contributions to be received each year that would be sufficient to fully cover the costs of benefit commitments being made to Members for the current year's service and to make a level payment that would fully amortize unfunded liabilities. Further, the MP 1 Funding fixed the City's contributions for a period of years at an agreed amount. This violated a number of requirements: the principle of on-going monitoring of the funding requirements of the Retirement System, the requirement that the funding be actuarially based and the actuarial principle that funding not be set for more than one or two years in advance.

²⁰ Presumably as a result of the Gleason litigation and settlement, the Charter was amended in 2004 to require annual funding of SDCERS. Had this provision been in place in 1996, the multi-year funding agreed to in MP 1 Funding would have been another violation of the Charter. Even in the absence of this provision in the Charter, however, the multi-year funding arrangement violated actuarial principles as described above.

As a result, by agreeing to funding based on specified amounts rather than actuarial calculations and by agreeing to funding at specified levels for a fixed number of years, MP 1 Funding violated each of the legal requirements described above and the actuarial principles referred to above. Thus, the Board violated its duties in approving the arrangement.

MP 1 Funding was presented by the City Manager as a proposal to stabilize the City's funding obligation. In essence, the proposal violated a key purpose of Proposition 162, "to prohibit ... any executive or legislative body of any political subdivision of this state from tampering with public pension funds." [Proposition 162, Section 3(e)]

iii. Assistance from Fiduciary Counsel and Actuary

In 1996, the Board's then fiduciary counsel concluded that it was proper for the Board to agree to a reduction in the City's contributions to less than actuarially determined levels because there was a corresponding advantage to the SDCERS Members. That conclusion was incorrect.

In his September 18, 1996 opinion letter, Dwight Hamilton discusses the application of Claypool v. Wilson, (1992) 4 Cal.App.4th 646, to the question of whether the Board was properly discharging its fiduciary duties in accepting MP1 Funding, the so-called Contribution Rate Stabilization Plan. Hamilton's analysis of the holding in Claypool, that a modification of a vested pension right is reasonable only if it bears some material relation to the theory of a pension system and its successful operation, and if the modification (which results in a disadvantage to employees) are accompanied by comparable new advantages to the members, is accurate. However, his conclusion failed to take into account two key factors: first, voting to permit SDCERS to be funded on a less than actuarially sound basis was improper; and, second, the 1992 amendment to the Constitution and case law that was current at the time of his opinion were contrary to his conclusion.

Hamilton notes the City's difficulty in working with the wide fluctuations in the employer's contribution rates under the Projected Unit Credit actuarial method, instituted in 1992. He notes that the contribution rates had been driven to an unanticipated level and that the fluctuation in these rates had caused severe budgeting problems for the City. He stated that the City Manager's Contribution Rate Stabilization Plan was a modification of the pension system designed to effect economies for the benefit of the City and that this modification was accompanied by an increase in benefits and other advantages granted to the beneficiaries and members.

Hamilton concludes:

"The stabilization of employer contribution rates is directly related to the functioning and integrity of the system. Thus, the modification appears to comply with the modification of vested rights rules of Betts and Claypool, and is consistent with the duty to minimize employer contributions set forth in Article XVI, section 17(b) of the California Constitution."

In citing to Claypool, Hamilton failed to take into account language from the opinion that contradicted his conclusion. In analyzing the propriety of trading off funding for increased benefits, the court stated:

"The justification must relate to considerations internal to the pension system, e.g., its preservation or protection or the advancement of the ability of the employer to meet its pension obligations. Changes made to effect economies and save the employer money do 'bear some material relation to the theory of a pension system and its successful operation' **That is not to say that a purpose to save the employer money is a sufficient justification for change. The change must be otherwise lawful** and must provide comparable advantages to the employees whose contract rights are modified. **We hold only that the monetary objective will not invalidate a modification which is otherwise valid.**" Id. at 666 [citation omitted]. [Emphasis added]

The court points out the overriding factor that Hamilton ignored in advising the Board, that the change in funding "must be otherwise lawful." MP 1 Funding was not, as discussed above.

The second factor that both Hamilton and the Board failed to take into was the last sentence of Article XVI, Section 17(b) of the Constitution which states that the Board's duty to provide benefits to the Members outweighs any other duty, including the duty to minimize employer contributions. Indeed, even before this amendment to the Constitution, the court in City of Sacramento v. Public Employees Retirement System, (1991) 229 Cal.App.3d 1470 had made it clear that minimizing employer contributions does not outweigh the duty of the Board to deliver benefits to participants. As the court stated (at page 1493):

"We agree with CalPERS that, even assuming article XVI, section 17 creates a duty to minimize employer contributions, **it cannot be construed to require PERS to manage the retirement system in a way which would favor an employer over the beneficiaries to whom it owes a fiduciary duty.**" [Emphasis added]

By agreeing to MP 1 Funding, the Board violated the paramount duty of maintaining an actuarially sound retirement system. Stated another way, the Board could not under

any circumstances permit the Retirement System to become actuarially unsound, regardless of how beneficial this was for the City or the Members.

The Actuary for SDCERS did not provide either projections or an opinion to the Board in connection with its consideration of MP 1 Funding. As stated by Navigant Consulting, the actuary “provided an estimate of the increase to the actuarially calculated contribution rates resulting from the enhanced benefits....However, Mr. Roeder’s letter does not compare the increases or what the new rates would be to the schedule included in the City Manager’s proposal.” [Section VII.D.6.a] While the actuary is reported in minutes of a June 11, 1996, Board function to have stated that “the proposal was actuarially sound given the appropriate sunset provisions,” he did not provide, nor did the Board request projections of contribution rates or sensitivity analyses on the System’s funding that reflected the proposed benefits. [Id.]

Therefore, the Board neither received nor asked for any in-depth analysis by the actuary of the projected impact of the course of action it was being asked to pursue, that is, approval of a non-actuarially based, fixed funding schedule that would cause the funded status of the Retirement System to erode over time. (This anticipated erosion effect in the MP 1 Funding proposal is reflected in the concern over creation of the appropriate “trigger” for increased funding by the City; the fact that the trigger was set at 10% below the then-current funded level indicates that it was anticipated that the funded status would decline.)

iv. Other Issues

It might be argued that the recently decided Mathews case in Ventura County Superior Court reflects legal principles that would justify the Board’s conduct in approving MP 1 Funding. As previously discussed, in that case the court found that it was permissible for the board of administration of the Ventura County Employees Retirement Association (VCERA) to “excuse” Ventura County from making contributions to the pension fund. It appears from the facts that to the extent the investment return on the assets of VCERA produced earnings in excess of the earnings assumption used in funding the plan, these were placed in an “undistributed earnings reserve” and were used in calculating the actuarial funded status of the fund. The facts of that case are vastly different from the situation that faced the SDCERS Board at the time of MP 1. In the case of the Ventura County pension fund, the court found, among other things:

- VCERA’s funds were managed in an sound actuarial manner
- VCERA was over funded (and over a period of years, the average funding ratio of the fund was 100%)
- The actuaries employed by VCERA were competent and independent
- The actuarial methods used by VCERA’s actuaries were within sound actuarial guidelines and followed generally accepted actuarial principles

- The retirement board's decision-making process with respect to actuarial determinations, including the setting of employer contribution rates, was deliberative and well informed.

The court also noted that when the actuarial funding ratio fell in 1995 to 85.5%, the County issued pension obligation bonds that permitted the funding ratio to be increased to over 100% the next year.

Contrast these facts with the SDCERS situation at the time of MP 1:

- The funding ratio in 1996 was already below 100% and the ratio was projected to fall even further as a result of both the increases in benefits and the proposed under-contribution rates proposed by the City.
- The way in which the contribution rates under MP 1 were set was not actuarially sound.
- The Board failed to act prudently (as discussed in the next part of this discussion).

Even though it is possible to conclude, as the court in the Mathews case did, that it is permissible for a retirement system board to give the employer a funding "holiday," this is only permissible if other requirements are met, including especially the requirement that the pension fund be actuarially sound. In the case of SDCERS, even without the approval of the benefit increases in 1996, the Retirement System was already less than 100% funded and would only fall further behind when the benefit increases were taken into account at then current funding levels. The funding contributions approved in MP 1 Funding would, stated simply, make matters worse.

3. Discussion of Fiduciary Requirements

Because of the violation of law related to the funding of the Retirement System arising out of MP 1 Funding, it is unnecessary to address the fiduciary violations that occurred in order to conclude that the Board's actions were improper. Nevertheless, we will do so in the next part of this discussion, since we believe this discussion may prove to be valuable to the current Board members.

For all practical purposes, the conclusion that the approval of MP 1 Funding resulted in violations of the legal requirements regarding actuarial funding of the retirement system could be the end of the legal analysis, because even if the Board thought it was acting properly and in good faith and even if the Board had engaged in a proper fiduciary process (which we conclude below it did not), the MP 1 Funding did not comply with the law. As the court concluded in Westly v. California Public Employees' Retirement System Board of Administration, (2003) 105 Cal App.4th 1095, 1114:

“The [CalPERS] Board...has confused the measure of its power with the reasonableness of its exercise of the power. The rule is first, the application of the rule is second. While Art. XVI, §17 imposes fiduciary duties upon the Board to provide benefits to participants and their beneficiaries and to minimize the risk of loss and maximize the rate of return, **it is obvious these duties must be performed by the [CalPERS] Board and its employees within the applicable law. There was no need for the [CalPERS] Board to present evidence of the reasonableness of its decisions *with respect to the exercise of a power it does not have.*”** [Emphasis added]

What the court in the Westly case points out is that a retirement board must act within the law. Actions that violate the law, no matter how reasonable, no matter how well-intentioned, no matter how well undertaken from a fiduciary process standpoint, are improper and cannot be upheld. Thus, even if we had concluded that there were no flaws in the process used by the Board in approving MP 1 Funding – which we have not – we would still be forced to conclude that the approval was improper because of the result – an actuarially unsound plan – that it produced.

a. Fiduciary Laws

In assessing the fiduciary obligations of the Board, it is appropriate to review the various legal requirements and principles discussed above in Part III.B. These fall into the following categories:

- (1) California Constitution: The Board has the obligation to act in the best interest of the Members of the Retirement System, for the exclusive purpose of providing retirement benefits (which takes precedence over all other duties) and in accordance with the prudent person rule. That rule requires that the Board members act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.”
- (2) Case Law: A public retirement system is a trust and the Board members are in a trust relationship with the Members. They owe the Members a duty of good faith and fair dealing. The Board members must not administer the retirement system in a way that favors the employer over the Members.
- (3) State Law Requirements: Provisions of the Government Code impose obligations virtually identical to those under the Constitution. In addition, the Probate Code imposes the following duties on retirement board members: a duty of loyalty to the beneficiaries of the trust, which means an obligation to act in the best interest of the beneficiaries at all times; a duty to act prudently in

delegating their duties and responsibilities and in appointing and supervising their agents; and responsibility for the acts of co-trustees in certain circumstances.

(4) City Charter and Municipal Code: Section 143 of the Charter provides that the members of the Board of Administration “retain plenary authority and fiduciary responsibility for investment of moneys and administration of the system as provided for in article XVI, section 17 of the California Constitution.” Thus, the California Constitutional fiduciary duties are incorporated into the law of the City. The provisions of the Municipal Code imposes actuarial duties (discussed above) and do not expand on the fiduciary obligations of the Board members.

(5) ERISA: Because of the legislative history of amendments to the California Constitution in 1984, ERISA is especially relevant to the interpretation of the duties of retirement board members. One of the key purposes of the 1984 amendments was to “provide that the fiduciary shall.... discharge the duties pursuant to a specified standard which is substantially similar to the... standard in the federal Employee Retirement Income Security Act of 1974.” The provisions of the California Constitution are virtually identical with the fiduciary duties imposed under ERISA.

Based on these authorities, we described the fiduciary duties of the Board in Part III.B. above as follows:

- The fiduciaries must act for the exclusive purpose of providing retirement benefits to the Members, and this duty takes precedence over all others.
- The fiduciaries must meet the prudent person rule in carrying out their duties, which requires them to engage in a prudent process in making decisions.
- The prudent person rule consists of procedural prudence and substantive prudence.
- The prudent process requires the fiduciaries to determine all relevant information (both what they know is relevant and what they should know is relevant) that they need in order to make an informed decision.
- The prudent process requires the fiduciaries to undertake an investigation to obtain all relevant information.
- The fiduciaries may rely on experts and others to assist them in carrying out their duties so long as they have no reason to doubt the competence, integrity or responsibility of such persons.
- The fiduciaries may rely on experts and others but must make their own independent judgment once they receive that assistance. They may not rely blindly on the advice of experts.

- The fiduciaries must make informed and reasoned decisions once they have gathered and analyzed the relevant information.

b. Analysis of Fiduciary Breaches

Next we examine the conduct of the Board as compared to these tests of fiduciary conduct:

- The fiduciaries must act for the exclusive purpose of providing retirement benefits to the Members and this duty takes precedence over all others.

As discussed above with respect to the actuarial issues, the Board members approved an arrangement that permitted the Retirement System to be funded on a non-actuarial basis and to proceed down a path that could lead to actuarial unsoundness (as described above). Even acknowledging Navigant Consulting's conclusion that the Retirement System "has sufficient assets to pay benefits due to all current retirees," [Section IV, Summary of Findings and Conclusions] the actuarial unsoundness (as described above) of SDCERS could prove to be detrimental to Members in the future. As a result of the failure to ensure that SDCERS is actuarially sound, it is possible to conclude that the Board members did not act in the best interests of the participants nor for the exclusive purpose of providing them with benefits. On this basis, in addition to violating their legal duties with respect to actuarial funding of SDCERS as discussed above, it is possible to conclude that they breached their fiduciary duty to the participants.

- The fiduciaries must meet the prudent person rule in carrying out their duties, which requires them to engage in a prudent process in making decisions.
- The prudent person rule consists of procedural prudence and substantive prudence.
- The prudent process requires the fiduciaries to determine all relevant information (both what they know is relevant and what they should know is relevant) that they need in order to make an informed decision.
- The prudent process requires the fiduciaries to undertake an investigation to obtain all relevant information.
- The fiduciaries must make informed and reasoned decisions once they have gathered and analyzed the relevant information.

Because these five items all relate to the prudent person requirement, including the prudent process, we discuss them together. We have concluded that the Board did not engage in a prudent process or make an informed and reasoned decisions as required under the prudent person rule. As a result, we have concluded that the Board breached its fiduciary duty to the Members in approving MP 1 Funding. This is true for several reasons:

The Board should not have put itself in the position of voting on MP 1 in the first place. That is, it appears to have been understood by all parties that MP 1 consisted of both the funding relief to the City and the benefit increases to the Members. The latter were, at least informally, contingent on the Board's approval of the benefit increases. The Board should have advised the City that it would consider the proposed funding relief but that it would not be involved in the issue of increased benefits because that was up to the City Council and not the Board. If the benefit increases were approved, the Board and its actuary would take them into account in determining the proper funding level, but it would not negotiate a funding level in return for benefit increases for the Members.

Further, based on the information provided in the Navigant Consulting discussion, it appears that the Board's process was flawed. Though it did engage fiduciary counsel²¹ and asked the actuary for his views, it did not sufficiently question the advice it received and appears to have relied too heavily on its experts and staff. The Board ignored or swept aside concerns expressed by certain of its members who ultimately voted against the proposal.

Perhaps most important, the Board failed to ask the single most important question that it should have asked when the proposal was presented: what would be the long-term impact on the Retirement System if the proposal were accepted? We believe that in order to properly fulfill the prudent process requirements, the Board should have obtained projections at the time it considered MP 1 Funding of the impacts that the increase in benefits and the reduction in City contributions would have on the funded status of the Retirement System. It does not appear from the facts developed by Navigant Consulting that anyone on the Board thought to ask the actuary for such projections.

Indeed, we are not aware of anything in the record indicating that the Board thereafter questioned, from year to year, what the on-going effect of MP 1

²¹ At the time, the Board had two sets of counsel – the City Attorneys' office and outside fiduciary counsel. As noted by Navigant Consulting, the City Attorneys' office recused itself on the grounds that the attorneys in that office would personally benefit from the outcome of the Board's decision, thus depriving the Board of the benefit of advice from its principal legal advisor. While it is true that the City attorneys would benefit, in our view the City Attorney should have pointed out that the Board should not be making any decision that could be construed as affecting benefits, since that was not the Board's role but rather the role of the City Council. In that sense, there was no real conflict. Further, it is also our view that at the very least, the City Attorney should have pointed out that a majority of the Board members had the same conflict if one existed.

Funding was actually having on the System. While we cannot speculate whether the City would have agreed to a modification of the arrangement if the Board had raised the issue, as fiduciaries the Board nonetheless had the obligation to monitor the situation and approach the City with its concerns as it saw the funded status of SDCERS erode.

4. Remedy

As discussed in the analysis of MP 1, under the authority of Board of Administration v. Wilson, supra, the Board has an obligation to take steps to remedy the serious under funding and actuarial unsoundness of the Retirement System, to the extent this was not corrected in connection with the Gleason settlement, and seek to collect this funding shortfall from the City.

It will be up to the Board to determine the amount of the unfunded liability resulting from MP 1 Funding and MP 2 Funding and the proper method of recouping this amount from the City. Given the serious current under funded status of the Retirement System, the Board in its fiduciary capacity should explore methods for and the proper timing of collection of these amounts with its actuary and independent counsel. In the process and in light of the possibility that the City might seek protection in a Bankruptcy filing, the Board should also consult with expert counsel on what steps it might take to seek to protect the Retirement System and its Members from such an eventuality (such as the step taken in the Gleason settlement, in which the Retirement System obtained security for the City's funding obligations).

Clearly, this is a complex issue that will require considerable study, and we express no opinion on this issue.

B. Manager's Proposal 2

1. Summary of Conclusions

Based on the evidence developed by Navigant Consulting and discussed in earlier Sections of this Report, we have concluded that the Board acted improperly in approving MP 2, as it had when it approved MP 1. To the extent MP 2 continued to permit the City to fund the Retirement System on a basis that was not actuarially based, it violated state and municipal law and was a breach of fiduciary duty by the Board.

The discussion that follows addresses only the funding aspects of MP 2 and the fiduciary and actuarial issues related thereto.²² For the reasons discussed above with

²² Much of the information appearing in this part duplicates material appearing in the discussion of MP 1. We believe this is necessary for two reasons: first, we believe each analysis

respect to MP 1, we have not assessed nor drawn any legal conclusions with respect to increases in benefits to City employees that occurred in conjunction with MP 2. The comments that follow regarding the impropriety of MP 2 should be read in this context. In discussing the funding issues of SDCERS and the Board's activities related to funding, we refer to the arrangement as "MP 2 Funding."

In its Summary of Findings and Conclusions, Navigant Consulting makes the following statements (among others) [Navigant Consulting findings, Section IV; hereafter, references to Sections appearing in brackets are to the Navigant Consulting discussion]:

6. The City contributed less than the Actuarially Required Contribution resulting in the underfunding of SDCERS since at least as early as 1996. The City has not made up for contribution shortfalls from previous years.
7. MP1 and MP2 did not make economic or actuarial sense because the agreements decreased the City's contribution to SDCERS at the same time as the City granted benefit improvements to City employees.
8. The SDCERS' Board approved MP1 and MP2 despite concerns raised by Board members, the Board's fiduciary counsel and the System's actuary.
9. The annual actuarial valuations prepared for SDCERS contained misleading statements about the funding objectives and practices.
10. The SDCERS' fiduciary counsel and actuary could have more clearly explained their concerns to the Board and could have been more forthcoming in stating a position with regard to both MP1 and MP2.

Based on these Findings and Conclusions and other evidence presented by Navigant Consulting in earlier Sections of this Report, we have reached certain legal conclusions. The following is a summary of those legal conclusions. As noted in the Introduction to this Legal Analysis Section of the Report, we have relied on the investigation, findings, conclusions and evidence developed by Navigant Consulting without any independent verification on our part. Based on those items, we believe that, if this matter were litigated, the substantial weight of the evidence would lead a court to conclude:

- MP 2 Funding failed to assure the "competency" of the Retirement System assets as required by the state Constitution.
- MP 2 Funding violated the contract clauses of the state and federal Constitutions by permitting SDCERS to continue to be significantly under funded.

should stand on its own; second, the similarities between the two situations require a discussion of much of the same material.

- MP 2 Funding violated the state Constitution's restriction on political interference in the administration and funding of SDCERS.
- The Board of Administration breached its duty to follow the law with respect to the funding of the Retirement System and in the process violated the State Constitution, the Government Code, the City Charter and the Municipal Code.
- The Board of Administration violated its fiduciary duty to the Members of SDCERS by failing to act prudently for the exclusive purpose of providing an adequately funded plan for the Members. In particular, the Board failed to:
 - Conduct a proper investigation of the relevant facts;
 - Failed to give adequate consideration to facts and questions raised by members of the Board and the Board's actuary and fiduciary counsel that did not support the MP 2 Funding proposal;
 - Failed to adequately supervise and monitor the SDCERS staff to ensure that they were developing and presenting to the Board the proper information on which to make an informed and reasoned decision;
 - Failed to make an informed and reasoned decision.
- The Board of Administration again breached its duties not to engage in activities beyond the scope of its responsibilities and to avoid participating in activities that violate the enunciated intent of Prop. 162 by entering into a contract that coupled increases in benefits with reductions in funding. The determination of the benefits payable to the Members of SDCERS is properly made only by the City Council, and the Board should not have participated in that determination.
- To the extent an underfunding exists as a result of the MP 1 Funding and MP 2 Funding arrangements that were not corrected in connection with the Gleason settlement, the Board is obligated to collect from the City the difference between the contributions actually made and those that should have been made had SDCERS been funded on an actuarial basis, plus a reasonable rate of interest. The Board should consult with its actuary and legal counsel to determine the proper timing of the owed amount and should request that the City pay the unpaid balance accordingly.

2. Discussion of Actuarial Issues

a. Actuarial Requirements

In assessing the actuarial requirements imposed on the Board, it is appropriate to review the legal requirements and principles discussed above in Part III.C. These fall into the following six categories:

- (1) California Constitution: The Board has the obligation to provide for actuarial services in order to assure the competency of the assets of the

Retirement System.²³ For these purposes, “competency” means adequacy or actuarially soundness. Further, one of the principle purposes of the 1992 revisions to Article XVI, Section 17 of the Constitution was to assure that public retirement systems would remain free from political interference.

(2) Case Law: Members of a retirement system have a contractual right under the contract clauses of the state and federal Constitutions to an actuarially sound pension fund. This means calculating the contributions based on actuarial valuations of the assets and liabilities of the retirement system, using established actuarial principles. [See Part III.C.2 above] These principles are discussed further below.

(3) Government Code: Applicable state law requires that a public retirement system be maintained on an actuarially sound basis and that contributions be in amounts that will accumulate a retirement fund sufficient to carry out the promise to pay benefits without further contributions. As stated by the Attorney General in a recent opinion commenting on the Government Code provisions related to funding:

“Contributions [to a public retirement system must be] made in amounts actuarially calculated to maintain the trust fund **at a level sufficient to pay the benefits that have been promised to past and present employee members.**” October 4, 2005 AG Opinion No. 04-710 (October 4, 2005). [Emphasis added]

(4) City Charter: Section 143 of the Charter imposes several distinct requirements with respect to the actuarial determination of funding of the Retirement System:

- The actuary must determine the mortality, service, experience or other tables to be used in funding the Retirement System.
- The actuary must determine the valuation of the Retirement System.
- The Board must approve the calculations and determinations made by the actuary.

²³ The Constitution imposes on the board of a public retirement system the “sole and exclusive responsibility” for administering the Retirement System to “assure prompt delivery of benefits” and the “sole and exclusive power to provide for actuarial services in order to assure the competency of the assets....” [Emphasis added] Read together, we conclude that the responsibility to provide benefits and the power to provide for actuarial services creates an obligation on a retirement system board to employ actuarial services to assure the competency of the assets.

- The Retirement System must be based on the mortality, service, experience or other tables calculated by the actuary and the valuation determined by the actuary, as approved by the Board.

(5) Municipal Code: The Municipal Code imposes additional requirements on the Board with respect to funding:

- The Board is required to engage an actuary and to have the actuary perform a valuation of the assets and liabilities of the System each year.
- At least once every five years, the Board must have an actuary to conduct a thorough investigation of the mortality, service and compensation experience of Members.
- Based upon its own investigations, valuations and determinations and the recommendations of the actuary engaged by the Board, the Board must adopt the mortality, service and other tables and interest rates it deems proper for the funding of the Retirement System.

(6) Actuarial Principles: A key actuarial principle is the concept of an actuarially sound plan. As stated in Section IX.D., Actuarial Soundness, of this Report, actuarial soundness may be defined as follows:

“The financial objective of the pension plan shall be to establish and receive contributions which will remain approximately level from year to year and will not have to be increased for future generations of citizens. This objective is achieved when contributions received each year by the pension fund are sufficient both, (1) to fully cover the costs of benefit commitments being made to employees for their service being rendered in such year and, (2) to make a level payment which, if paid annually over a reasonable period of future years, will fully cover the unfunded costs of benefit commitments for service previously rendered.”

The elements of actuarial soundness under this definition are the following:

- Contributions should be level from year to year and not transfer the liability for funding benefits of current Members on future generations.
- Contributions received each year should be sufficient to fully cover the costs of benefit commitments being made to Members for the current year’s service.
- Contributions received each year should also be sufficient to make a level payment that will fully amortize unfunded costs for benefits related to previously rendered services.

The Government Code provision requiring that “Contributions be in amounts which will accumulate at retirement a fund sufficient to carry out the promise to pay benefits to the individual on account of his service as a member of the system, without further contributions from any source” is consistent with the foregoing definition.

Further, as reflected in Section IX.D. of this Report, “achieving a balance between benefit security and funding stability is a delicate task. It requires ongoing ‘financial engineering’---diligence in monitoring a plan’s fiscal health and making course corrections in a timely and planned manner.” This suggests that contributions levels should not be approved on a multi-year basis but should be reassessed on an ongoing basis to ensure that the retirement system remains actuarially sound. This is borne out by the GASB rules described in Section X.A., Authoritative Accounting Literature, which indicates that “the actuarial valuation should occur yearly (unless the plan calls for a biannual valuation)...[and] [t]he actuarial valuation should include all pension benefits covered by the plan terms at the valuation date.”

We understand that there may be a variety of possible definitions of “actuarial soundness.” Nevertheless, in light of the Government Code provision quoted above and the other provisions of California law related to actuarial funding of public retirement systems, we believe that the better reasoned view and the one that would be accepted by the California courts (and one that makes common sense) is that the benefit liabilities and the system’s assets would approximate one another in value. As a result, for purposes of the legal analysis that follows, in applying the term “actuarial soundness” we use that definition.

b. Analysis of Actuarial Requirements

As reflected in the Findings and Conclusions developed by Navigant Consulting, the result of MP 2 Funding was the continuation of a retirement system that was not actuarially based and that continued to be under funded. Based on the discussion of actuarial principles contained in Section IX, Actuarial Analysis, of this Report and the definition of actuarial soundness stated above, this resulted in an actuarially unsound retirement system. Further, the funding proposal contained in MP 2 was not actuarially based. As a result, MP 2 Funding did not satisfy any of the six criteria listed above and, therefore, violated the funding provisions of the State Constitution, the Government Code, the City Charter and the Municipal Code.

While all of the six criteria were violated by the Board’s approval of MP 2 Funding, the violation of any one of them would have been a breach of the Board’s duties.

i. Actuarial Soundness

In reaching these conclusions, we start with an assessment of whether SDCERS met the elements of an actuarially sound plan either before or after MP 2 Funding.

- Contributions should be level from year to year and not transfer the liability for funding benefits of current Members on future generations. Navigant Consulting concluded that this requirement was not met. [See Navigant Consulting Conclusion 1, above]
- Contributions received each year should be sufficient to fully cover the costs of benefit commitments being made to Members for the current year's service. Navigant Consulting concluded that this requirement was not met. [See Navigant Consulting Conclusion 1, above]
- Contributions received each year should also be sufficient to make a level payment that will fully amortize unfunded costs for benefits related to previously rendered services. Navigant Consulting's findings reflected that this was not true. [See Navigant Consulting Conclusion 1, above]

ii. Failure to Comply with Legal Requirements

We now look to each of the legal requirements separately. While we have determined that the board failed to comply with all six of the indicated requirements, we note that non-compliance with any one of them in approving the MP 2 Funding would have been a violation of law by the Board.

- The Constitutional Requirement: Based on the Navigant Consulting findings, we conclude that the Board failed to assure the "competency" of the assets of SDCERS by failing to maintain the actuarial soundness of the Retirement System (as described above) [See Navigant Consulting Conclusion 1, above] *See also* the discussion of the Government Code below for additional analysis of the actuarial soundness issue.
- The Case Law: Because SDCERS was not actuarially sound (as described above and for the reasons set forth under the discussion of the Government Code below), the MP 2 Funding violated the contract clauses of both the state and federal Constitutions.
- The Government Code: The level of contributions approved in MP 2 Funding were not in amounts that would accumulate a retirement fund sufficient to carry out the promise to pay benefits without further contributions in the future and, further, were not actuarially calculated nor

established at a level that would maintain the trust fund at a level sufficient to pay the benefits to past and current Members. Indeed, it appears that the funding levels agreed to under MP 2 Funding, after taking into account the benefit increases agreed to by the City at the same time, were not sufficient to cover the normal cost of the retirement system each year, much less amortize a portion of the unfunded liability.

- The City Charter: MP 2 Funding permitted funding that was not determined by the actuary and contributions that were not based on actuarial tables or other calculations made by the actuary, both as required by Section 143. Therefore, the Board violated the Charter in approving MP 2 Funding.²⁴
- The Municipal Code: MP 2 Funding did not provide for funding that was based the recommendations of the actuary or on the Board's own investigations, valuations and determinations made in reliance on those recommendations. Thus, MP 2 Funding violated the Municipal Code provisions related to funding.
- Actuarial Principles: MP 2 Funding did not comply with sound actuarial principles. It did not provide for contributions to be received each year that would be sufficient to fully cover the costs of benefit commitments being made to Members for the current year's service and to make a level payment that would fully amortize unfunded liabilities. Further, the MP 2 Funding fixed the City's contributions for a period of six years at an agreed amount. This violated a number of requirements: the principle of on-going monitoring of the funding requirements of the Retirement System, the requirement that the funding be actuarially based and the actuarial principle that funding not be set for more than one or two years in advance.

As a result, by agreeing to funding based on specified amounts rather than actuarial calculations and by agreeing to funding at specified levels for a fixed number of years, MP 2 Funding violated each of the legal requirements described above and the actuarial principles referred to above. Thus, the Board violated its duties in approving the arrangement.

MP 2 Funding was a further attempt by the San Diego City Manager to balance the City's budget and avoid the consequences of the "trigger" established in MP 1 Funding. Once again, by injecting the executive leadership of the City into the funding process for

²⁴ Presumably as a result of the Gleason litigation and settlement, the Charter was amended in 2004 to require annual funding of SDCERS. Had this provision been in place in 2002, the multi-year funding agreed to in MP 2 Funding would have been another violation of the Charter. Even in the absence of this provision in the Charter, however, the multi-year funding arrangement violated actuarial principles as described above.

the explicit purpose of having SDCERS funded on a less than actuarially sound basis, the contract violated a key purpose of Proposition 162, “to prohibit ... any executive or legislative body of any political subdivision of this state from tampering with public pension funds.” [Proposition 162, Section 3(e)]

iii. Assistance from Actuary

The Board did consult with its actuary and fiduciary counsel in connection with its consideration of MP 2 Funding. Unfortunately, as indicated in the Navigant Consulting discussion and findings, the actuary presented information and discussed certain issues but gave no opinion to the Board regarding the effect of the proposal, and fiduciary counsel expressed significant concerns about the MP 2 Funding proposal but then changed his mind for reasons that were not made clear to the Board. Indeed, his final opinion simply failed to mention a number of the concerns that were raised in the first draft of the opinion. [Section VII.F.8.a; Navigant Consulting Conclusion 5, above]

As reflected in the Navigant Consulting findings, the actuary presented scenarios to the Board in the summer of 2002 that suggested the Retirement System was at or near the trigger for additional funding by the City as agreed to under MP 1. Indeed, Navigant Consulting states that “the projections [presented to the Board by Rick Roeder], other than the 12% earnings scenario, show the funded ratio declining below 80%.” Since it would appear that in mid-2002, a 12% earnings projection was unrealistic, the Board had information from which to conclude that the Retirement System was actuarially unsound, even if they applied as a definition of “unsoundness” the 82.3% trigger level of MP 1.

In 1996, in connection with the MP 1 Funding proposal, the actuary relied on the existence of the trigger as a mechanism that would help protect the Retirement System. The actuary took comfort at that time that the funded status of SDCERS would not fall below the 82.3% trigger amount. [Section VII.F.8.a] It is unclear from the record whether the actuary felt in 1996 that SDCERS would be considered actuarially sound at any point above the trigger, but it does appear that he felt it would be unsound if it fell below that amount. Nevertheless, in 2002, when it was clear that the Retirement System was approaching the trigger point, the Board did not seem especially concerned – and Mr. Roeder did not issue any specific warning – that acceptance of the MP 2 Funding proposal would result in a funded status below the level previously believed to be unsound. [Id.]

In his final correspondence with the Board regarding MP 2 Funding in November 2002, Mr. Roeder told the Board unequivocally that “From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager’s Proposal and the 82.3% trigger.” He also pointed out that “if the 82.3% accelerated funding trigger is hit the **ramp up to full PUC rates** will be accelerated....” [Emphasis added] This statement

makes it clear that the City was not funding at the full actuarial rate, in violation of the City Charter and Municipal Code provisions. Though Mr. Roeder failed to express an opinion on the question of whether the proposal was proper or appropriate [Id], these statements by the Board's actuary should have been sufficient for the Board to vote against the proposal, to conclude that the MP 2 Funding proposal was not actuarially sound and should be rejected.

iv. Assistance from Fiduciary Counsel

It also appears that fiduciary counsel failed to consider in its final opinion that even if the Board engaged in a prudent analysis of the proposal and acted prudently in accepting it, the proposal nonetheless violated the City Charter and other provisions (as noted above) and thus was improper. As reported by Navigant Consulting, fiduciary counsel Robert Blum issued a preliminary opinion in which he stated a number of concerns, one of which was that the System's funded ratio was the lowest it had been in 14 years. He also pointed out that the contributions under MP 2 Funding were less than the actuarially determined contribution rates under the annual actuarial valuation, and the contributions under the proposal (including member contributions) would not cover normal cost plus interest on past service liabilities. Finally, Navigant Consulting indicates that Mr. Blum stated that it appeared that neither the "safeguard floor" nor the contribution ramp-up of the proposal "works." In the context of his discussion, it appears that Mr. Blum was telling the Board that even with the supposed "safeguards" built into the MP 2 Funding proposal, these were no real protection for the Retirement System. [Section VII.F.8.b]

In light of the fact that the funding under the original structure proposed in June 2002 -- and which remained unchanged in the final agreement negotiated between the City and the Retirement System -- did not meet the actuarial requirements of the law, it is unclear how fiduciary counsel could then conclude in the opinion letter delivered to the Board in November 2002 that "it is our opinion that it would be a reasonable exercise of the Board's fiduciary responsibilities if the Board entered into the [MP 2] Agreement." As discussed in Westly v. California Public Employees' Retirement System Board of Administration, (2003) 105 Cal App.4th 1095, 1114, the Board must perform its duties within the law, and the good faith and reasonableness of conduct that violates the law is irrelevant. Fiduciary counsel failed to even mention the requirements regarding actuarial soundness under the state and federal Constitutions, the Government Code, the City Charter or the Municipal Code. [Id.]

v. Other Issues

The findings by Navigant Consulting lead us to conclude that neither the SDCERS actuary nor legal counsel provided adequate warnings to the Board about the actuarial soundness of SDCERS or the actuarial duties of the Board in considering the MP 2

Funding proposal. [See Navigant Consulting Conclusion 5, above] This observation should not, however, deflect criticism from the Board itself. Except for a few individuals (Richard Vortmann in particular – see Navigant Consulting discussion, Section VII.F.7.c), the Board members did not ask the types of questions they should have regarding their duties or the effect of the MP 2 Funding proposal on the actuarial soundness of SDCERS. Indeed, it is possible to conclude from the evidence presented that, as fiduciaries, they did not even understand that they should be asking these questions.

In our discussion of MP 1, we provided a detailed analysis of the Mathews case recently decided in Ventura County Superior Court and pointed out the differences between the situation facing the Ventura County retirement system board and that facing the SDCERS Board at the time it approved MP 1 Funding. By 2002, when the Board considered MP 2 Funding, the underfunding had increased materially and the SDCERS Retirement Administrator, actuary and at least one Board member were aware that the trigger level for increased funding had been or was about to be reached. [Id.] This is in contrast to the situation described in Mathews, where the retirement system was overfunded (that is, the assets exceeded the present value of the benefits) and the retirement board's decision making was deliberative and well-informed. This should be contrasted to the situation that existed at the time the Board considered the MP 2 Funding proposal where the Retirement System was funded at well below 100% and was in fact at or near the funding trigger deemed important in the MP 1 Funding arrangement.

3. Discussion of Fiduciary Requirements

Because of the violation of law related to the funding of the Retirement System arising out of MP 2 Funding, it is unnecessary to address the fiduciary violations that occurred in order to conclude that the Board's actions were improper. Nevertheless, we will do so in the next part of this discussion, since we believe this discussion may prove to be valuable to the current Board members.

a. Fiduciary Laws

In assessing the fiduciary obligations of the Board, it is appropriate to review the various legal requirements and principles discussed above in Part III.B. These fall into the following categories:

- (1) California Constitution: The Board has the obligation to act in the best interest of the Members of the Retirement System, for the exclusive purpose of providing retirement benefits (which takes precedence over all other duties) and in accordance with the prudent person rule. That rule requires that the Board members act "with the care, skill, prudence, and diligence under the

circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.”

(2) Case Law: A public retirement system is a trust and the Board members are in a trust relationship with the Members. They owe the Members a duty of good faith and fair dealing. The Board members must not administer the retirement system in a way that favors the employer over the Members.

(3) State Law Requirements: Provisions of the Government Code impose obligations virtually identical to those under the Constitution. In addition, the Probate Code imposes the following duties on retirement board members: a duty of loyalty to the beneficiaries of the trust, which means an obligation to act in the best interest of the beneficiaries at all times; a duty to act prudently in delegating their duties and responsibilities and in appointing and supervising their agents; and responsibility for the acts of co-trustees in certain circumstances.

(4) City Charter and Municipal Code: Section 143 of the Charter provides that the members of the Board of Administration “retain plenary authority and fiduciary responsibility for investment of moneys and administration of the system as provided for in article XVI, section 17 of the California Constitution.” Thus, the California Constitutional fiduciary duties are incorporated into the law of the City. The provisions of the Municipal Code imposes actuarial duties (discussed above) and do not expand on the fiduciary obligations of the Board members.

(5) ERISA: Because of the legislative history of amendments to the California Constitution in 1984, ERISA is especially relevant to the interpretation of the duties of retirement board members. One of the key purposes of the 1984 amendments was to “provide that the fiduciary shall.... discharge the duties pursuant to a specified standard which is substantially similar to the... standard in the federal Employee Retirement Income Security Act of 1974.” The provisions of the California Constitution are virtually identical with the fiduciary duties imposed under ERISA.

Based on these authorities, we described the fiduciary duties of the Board in Part III.B. above as follows:

- The fiduciaries must act for the exclusive purpose of providing retirement benefits to the Members, and this duty takes precedence over all others.
- The fiduciaries must meet the prudent person rule in carrying out their duties, which requires them to engage in a prudent process in making decisions.

- The prudent person rule consists of procedural prudence and substantive prudence.
- The prudent process requires the fiduciaries to determine all relevant information (both what they know is relevant and what they should know is relevant) that they need in order to make an informed decision.
- The prudent process requires the fiduciaries to undertake an investigation to obtain all relevant information.
- The fiduciaries may rely on experts and others to assist them in carrying out their duties so long as they have no reason to doubt the competence, integrity or responsibility of such persons.
- The fiduciaries may rely on experts and others but must make their own independent judgment once they receive that assistance. They may not rely blindly on the advice of experts.
- The fiduciaries must make informed and reasoned decisions once they have gathered and analyzed the relevant information.

b. Analysis of Fiduciary Breaches

Next we examine the conduct of the Board as compared to these tests of fiduciary conduct:

- The fiduciaries must act for the exclusive purpose of providing retirement benefits to the Members and this duty takes precedence over all others.

As discussed above with respect to the actuarial issues, the Board members approved an arrangement that permitted the Retirement System to be funded on a non-actuarial basis, to remain under funded and to remain actuarially unsound (as described above). Even acknowledging Navigant Consulting's conclusion that the Retirement System "has sufficient assets to pay benefits due to all current retirees," [Section IV, Summary of Findings and Conclusions] the actuarial unsoundness of SDCERS could prove to be detrimental to Members in the future. As a result of the failure to ensure that SDCERS is actuarially sound, it is possible to conclude that the Board members did not act in the best interests of the participants nor for the exclusive purpose of providing them with benefits. On this basis, in addition to violating their legal duties with respect to actuarial funding of SDCERS as discussed above, it is possible to conclude that they breached their fiduciary duty to the participants.

In addition, Navigant Consulting points out that some Board members served dual roles [Navigant Consulting Summary of Findings and Conclusions, Section IV, number 9] and some received extra benefits in connection with the steps being taken in connection with the MP 2 Funding agreement [Section VII.F.9]. To the extent these conflicts weighed materially in the decision to vote in favor of

the MP 2 Funding agreement, those Board members would appear not to have been acting for the exclusive purpose of providing benefits (though there is no clear evidence developed by Navigant Consulting nor any clear conclusion that this was the case).

Indeed, as discussed in Part III.B of this Legal Analysis Section, the Board members had a fiduciary duty to keep each other informed of information relevant to their decision-making. It appears that the two Board members, Mr. Saathoff and Ms. Webster, who would receive additional personal benefits under the MP 2 Funding proposal, failed to keep the rest of the Board informed. [Section VII.F.9, Board Members' Potential Conflicts of Interest] To the extent they did not provide this information to their fellow Board members, they breached their duties as fiduciaries.

- The fiduciaries must meet the prudent person rule in carrying out their duties, which requires them to engage in a prudent process in making decisions.
- The prudent person rule consists of procedural prudence and substantive prudence.
- The prudent process requires the fiduciaries to determine all relevant information (both what they know is relevant and what they should know is relevant) that they need in order to make an informed decision.
- The prudent process requires the fiduciaries to undertake an investigation to obtain all relevant information.
- The fiduciaries must make informed and reasoned decisions once they have gathered and analyzed the relevant information.

Because these five items all relate to the prudent person requirement, including the prudent process, we discuss them together. The Board was clearly admonished that it had an obligation to gather relevant information. This is shown in the draft opinion letter the Board received from its then fiduciary counsel, Robert Blum, respecting the MP 2 Funding proposal. He stated on page 11 of his draft opinion (provided to us by Navigant Consulting):

“...in making a decision with respect to the proposed amendment to the Manager’s Proposal, the Board **should gather and examine all relevant facts**, obtain the advice of its actuary and investment advisor, and evaluate the proposal in relation to the requirement to maintain the financial integrity and security of SDCERS. A court would likely review any decision by the Board to see if there was substantial actuarial evidence to support the Board’s decision.” [Emphasis added]

Blum had previously observed that

“The City has not increased its contribution rates over those in the Manager’s Proposal [that is, MP 1 Funding] to take account of the increased benefits due under the Corbett settlement, and the portion of that settlement relating to retirees is not included as a liability in the actuarial valuation....

“SDCERS current funding integrity and security has been adversely impacted by application of the Manager’s Proposal [that is, MP 1 Funding].”

There is no clear evidence in the Navigant Consulting discussion that indicates that these issues were addressed or that the Board had “substantial actuarial evidence to support” its decision. Indeed, there is no clear evidence that the Board engaged in the sort of information gathering and assessment its fiduciary counsel had suggested. This apparent failure suggests a failure to meet the prudent process requirement and thus a failure to act prudently.

The Navigant Consulting conclusions expressed at the end of the discussion of MP 2 indicate a number of respects in which the Board failed to meet the prudent person requirement. [Section VII.F.1] They point out that the Board disregarded concerns raised by some Board members and initially raised by its own actuary and fiduciary counsel. For example, the Board failed even to consider the questions raised by Richard Vortmann in his June 2002 letter to the Board [Section VII.F.7.c.]. Further, the Board did not analyze the City’s ability to pay the substantial funding shortfall that was being created. [Section VII.F.1]

There is no evidence in the Navigant Consulting discussion to suggest that the Board asked obvious questions regarding the long-term impact of the MP 2 Funding proposal, questions that would have helped the Board fulfill its duty to properly understand and evaluate the proposal. For example, we believe the Board should have asked the actuary to provide projections on the impact of the proposal on the funded status of the Retirement System and whether the proposal, if implemented, might lead to financial distress on the part of the City that the Board would need to address at a later date. It does not appear that the Board would need the advice of its experts to come up with these questions. The failure to ask questions of this type (whether these specific ones or others) indicate a lack of a prudent process and the failure to meet the prudent requirement imposed by the California Constitution, the Government Code and the City Charter.

To engage in a prudent process, the Board would need to have investigated the implications of the MP 2 Funding proposal more completely, especially as to the actuarial implications of the proposal, and to obtain all relevant information

regarding the proposal. As discussed above, they did not do so. The prudent person requirement imposed on the Board the duty to make an informed decision. This it did not do, and it is reasonable to conclude that this is a breach of fiduciary duty.

- The fiduciaries may rely on experts and others to assist them in carrying out their duties so long as they have no reason to doubt the competence, integrity or responsibility of such persons.
- The fiduciaries may rely on experts and others but must make their own independent judgment once they receive that assistance. They may not rely blindly on the advice of experts.

The Board did not ask important questions of its experts, such as why fiduciary counsel changed his opinion, whether the proposal was legal as well as prudent and whether the concerns expressed by its actuary were sufficient to require the Board to vote against the proposal. Further, the Board did not seek to find out whether any of its members might have a vested interest in the proposal, as it appears several did. [Section VII.F.1]

The inadequacies of the advice received from the actuary and fiduciary counsel are described above under the actuarial discussion. Suffice it to say here, the Board's apparent reliance on the opinion of fiduciary counsel without asking him why he changed his opinion and why he did not address in his final opinion letter the issues he initially raised indicates a failure to meet the procedural and substantive prudence requirements and too heavy a reliance on their counsel. Further, the failure to ask their actuary to provide an opinion on the impact of agreeing to the proposal and of the long-term impact of the MP 2 Funding arrangement similarly evidences a failure to act prudently.

c. Other Fiduciary Failures

We also note that section 5.b. of the MP 2 Agreement (provided to us by Navigant Consulting) gave the Board the authority to nullify the agreement to the extent required by its duties under the state Constitution and that "no one shall have any liability for losses or costs on account of such action." Thus, the Board had the opportunity to ignore the agreement and request a larger, actuarially sound contribution at any time without creating any liability for the Retirement System or the Board itself. This would have required the Board to monitor the situation from year to year and to make a new determination each year of whether it was appropriate to continue the MP 2 Funding arrangement.

We saw no evidence in the Navigant Consulting discussion that suggests the Board asked or took into account whether the Retirement System was actuarially sound after

approving MP 2 Funding. This failure to monitor the decision is also a fiduciary breach, and in the context of MP 2 Funding, a significant one in that the Board could have taken corrective action without running the risk of incurring any liability for changing its mind on the funding issue. Whether the City would have complied with a funding change required by the Board is unclear, but at least the Board would have fulfilled its fiduciary and legal obligation by demanding proper funding.

4. Remedy

As discussed in the analysis of MP 1, under the authority of Board of Administration v. Wilson, supra, the Board has an obligation to take steps to remedy the serious under funding and actuarial unsoundness of the Retirement System, to the extent this was not corrected in connection with the Gleason settlement, and seek to collect this funding shortfall from the City.

It will be up to the Board to determine the amount of the unfunded liability resulting from MP 1 Funding and MP 2 Funding and the proper method of recouping this amount from the City. Given the serious current under funded status of the Retirement System, the Board in its fiduciary capacity should explore methods for and the proper timing of collection of these amounts with its actuary and independent counsel. In the process and in light of the possibility that the City might seek protection in a Bankruptcy filing, the Board should also consult with expert counsel on what steps it might take to seek to protect the Retirement System and its Members from such an eventuality (such as the step taken in the Gleason settlement, in which the Retirement System obtained security for the City's funding obligations).

Clearly, this is a complex issue that will require considerable study, and we express no opinion on this issue.

C. "Plan Document" and IRS Issues

1. Summary of Conclusions – Plan Document Issues

Manager's Proposal 1, Manager's Proposal 2, the Corbett Settlement, the Presidential Leave Benefit and the operation of the 401(h) Fund all resulted in failures to operate the Pension Fund in accordance with its Plan Documents. In addition, the Corbett Settlement and the Presidential Leave Benefit resulted in "overpayments." These defects violate the requirements of the Code and related regulations, and constitute "Qualification Failures" and "Operational Failures" as defined under the IRS' Employee Plans Compliance Resolution System. All of these defects and results are fully explained and analyzed below. Finally, the violations described herein subject the Pension Fund to possible disqualification by the IRS.

2. Summary of Conclusions -- Payment of Administration Expenses From Retirement Plan Assets

Navigant Consulting's investigation has determined that "the costs to administer the retiree health benefits program appear to have been paid for with pension assets."²⁵ To the extent this is true, such payments amount to a violations of the Code's "exclusive benefit," "definite written program" and prohibited transaction requirements. These violations subject the Pension Fund to possible disqualification by the IRS.

3. Analysis of Plan Document Issues

a. Introduction

SDCERS operates as a trust for purposes of providing City employees with retirement, disability, death and post-retirement health benefits. City Charter Article IX §145. The City established SDCERS and, as the settlor of that trust, is solely responsible for establishing the amount of all benefits and making the actuarially required contribution to fund those benefits. City Charter Article IX §141. SDCERS has no responsibility or authority for establishing benefits and/or making contributions to fund those benefits. Rather, the responsibility of SDCERS and its Board is limited to administering the trust fund for the sole benefit of its participants.²⁶ As a part of that responsibility, SDCERS informs the City of the amount necessary to fund benefits, and the City is required to contribute that amount to the pension fund.²⁷

To comply with the City Charter and provisions of the Municipal Code, the Board employs an actuary to make an annual valuation of SDCERS's assets and liabilities. At least once every five years, SDCERS employs an actuary to perform a thorough investigation of the mortality, service and compensation experience of members and other persons receiving benefits, along with an actuarial valuation of assets and liabilities. *See* Municipal Code § 24.0901. Based on the findings and recommendations of the actuary, the Board establishes contribution rates for the various classes of members. The Board also adopts actuarial assumptions as necessary to provide benefits.²⁸ The Board is responsible for crediting appropriate interest to member and

²⁵ *See* Report, Article VI.

²⁶ *See* Article XVI, § 17(a) and (b) of the Constitution. *See also* City Charter Article IX, §144.

²⁷ Prior to 2002, the San Diego Municipal Code provided that the City would contribute a percentage of members' earnable compensation as determined by the SDCERS actuary pursuant to the annual actuarial valuation. (*See* Municipal Code § 24.0801 (2000)). In November of 2002, the Municipal Code was amended to provide that the City would contribute the amounts agreed to in the governing Memorandum of Understanding between the City and the SDCERS Board.

²⁸ *See id.* § 24.0904 and § 24.0902, "Adoption of Mortality, Service, Interest Rates and Other Tables. Based upon its investigations, valuations, determinations and the recommendation of the Actuary, the Board will adopt the mortality, service and other tables and interest rates it deems

employer contribution accounts and transferring amounts from such account to a reserve in order to fund retiree benefits. See Municipal Code §§ 24.0903 and 24.0904. The Board must also prepare an annual administrative budget for SDCERS and an annual report. *Id.* at §§ 24.0906 and 24.0911

As explained above, SDCERS has no obligation or authority whatsoever to contribute any amounts to the pension fund. Rather, all such contributions are required to be made by the City. The responsibility of SDCERS is to administer the Pension Fund for the *exclusive benefit* of the participants, pursuant to a *definite written program* as described in the Plan Documents, and otherwise comply with all applicable law. Based on Navigant Consulting's findings, we have determined that SDCERS failed to operate the Pension Fund in accordance with its Plan Documents and the law, as described below.

b. Manager's Proposal 1

Beginning in 1996, the City entered into the MP 1 agreement with the Board to stabilize the City's contribution rate to the Pension Fund. This agreement established a fixed employer contribution rate schedule over a multi-year period. The proposed modifications under MP 1 to the SDCERS funding system evolved into a comprehensive package of benefit improvements for SDCERS members, coupled with a fairly complicated mechanism for providing contribution relief to the City, as described in Navigant Consulting's Investigative Report. [Section VI.D] Ultimately, as Navigant Consulting explains, MP 1 brought about a substantial underfunding of the Retirement System.²⁹

At the heart of the MP 1 was "corridor funding." Corridor funding involves establishing specified contribution rates to achieve, over a number of years, actuarially calculated funding objectives. This is to be contrasted with a funding methodology, like that of SDCERS, that seeks to attain desired funding objectives by adjusting contribution rates on a periodic basis.

The Board's approval of the corridor funding of MP 1 permitted the City to fund the Pension Plan on a methodology other than the actuarially required basis. This is because, at the time of MP 1, the Municipal Code required the City to contribute to SDCERS "a percentage of earnable compensation as determined by the System's actuary

proper, and will revise the Members' contribution rates as it deems necessary, to provide the benefits of the Plan. The Board's decisions on matters covered by this section are conclusive, if arrived at in good faith. (*"Election of Safety Members to The Board" repealed; "Adoption of Mortality, Service, Interest Rates and Other Tables" added 4-2-2002 by O-19043 N.S.*)"

²⁹ This was not the first time the SDCERS Board engaged in the process of creating benefits. In 1991, SDCERS changed its actuarial funding method from EAN to PUC. This coincided with granting of additional benefits granted to City employees. Navigant Consulting states that "[t]his is the earliest instance Navigant Consulting has identified where the SDCERS Board effectively agreed to lowered contribution levels from the City in exchange for benefit enhancements..." See Article VI. A. of the Report.

pursuant to the actuarial evaluation required by Section 24.0901)(1)...³⁰ Benefits under MP 1, however, were not based on earnable compensation. Rather, those benefits were based on the fairly complex mix of non-actuarial factors described in Navigant Consulting's report. [Section VI.D.4] Therefore, under MP1, the Board agreed to a proposal that effectively prevented from taking into account demographic and other key actuarial factors necessary to comply with the City Charter and the Municipal Code. Furthermore, Navigant Consulting found no evidence that the Board even attempted to perform appropriate analysis to understand the short and long-term impact of the reduced funding on the actuarial soundness of the System.

In summary, approving the corridor funding aspect of MP1 required SDCERS to ignore its Plan Documents to the extent that the City was no longer required to contribute to the Pension Fund on an actuarially basis. Thus, MP 1 prevented the Board and the Board's actuary from complying with the requirements of the City Charter. This left the Board without the ability to adjust the City's contribution rates as necessary to reflect actuarial realities, such as changing demographics and investment experience.

As explained in the Navigant's Consulting's Investigative Report, the enhanced benefits under MP 1 were contingent upon the Board's approval of the contribution stabilization portion of MP 1. [Section VI.D.] Thus, the proposal and its approval made SDCERS a part of the benefit determination process, notwithstanding the fact that SDCERS had and has no authority to determine benefits. The law on this issue is clear. City Charter Article IX, Section 141, vests the City, not SDCERS, with sole responsible for establishing the amount of all benefits and making the actuarially required contribution to fund those benefits. Section 141 states, in relevant part, as follows:

The Council of the City is hereby authorized and empowered by ordinance to establish a retirement system . . . (a) For the retirement with benefits of an employee who has become physically or mentally disabled by reason of bodily injuries received in or by reason of sickness caused by the discharge of duty or as a result thereof to such an extent as to render necessary retirement from active service. (b) Death benefits for dependents of employees who are killed in the line of duty or who die as a result of injuries suffered in the performance of duty. (c) Retirement with benefits of an employee who, after ten years of service for which payment has been made, has become disabled to the extent of not being capable of performing assigned duties, or who is separated from City service without fault or delinquency. (d) For health insurance benefits for retired employees.

³⁰ Fomer Municipal Code Section 24.0801. This Code section was amended in 2002 to reflect the implementation of Manager's Proposal 2. See also City Charter Article IX, Section 143, which requires SDCERS Board approval of actuarial valuations before they become conclusive and final. Navigant Consulting's investigation has been unable to identify any of it and said the Board performed appropriate analysis to understand the short and long-term impact of the reduced funding on the actuarial soundness of the System.

The responsibility of SDCERS and its Board, on the other hand, is strictly limited to administering the trust fund for the sole benefit of its participants, in accordance with the Plan Documents. *See* Article XVI, Sections 17(a) and (b) of the Constitution, and Article IX, Section 144 of the City Charter.

In summary, because MP 1 in violated the legal requirements for actuarial funding of the retirement system and caused the Board to exceed, or otherwise operate outside of its authority, by engaging in the determination of benefits, it resulted in a violation of the Plan Documents.

c. Manager's Proposal 2

Effective November 18, 2002, the City of San Diego and the Board entered into a MP 2. Under MP 2, the City increased its annual contribution rate to pay for increased benefits given by the City to the Pension Fund participants. The purpose of the rate increase was to close the contribution rate gap between the fixed contribution rate schedule and the actuarially calculated rate under the PUC funding methodology and, thus, attempt to fix the substantial underfunding of the Pension Fund that occurred under (or at least was exacerbated by) MP 1. [Section VI.F.]

MP 2 had essentially the same elements as MP 1 in the sense that it represented the same violations of the terms of the Plan Documents. That is, MP 2 continues to put SDCERS and its Board in the position of determining benefits, which is a violation of its authority under Article IX of the City Charter Section 141, and to disregard the actuarial requirements of the City Charter. [Id.] And as a result, there is a continuation of the Plan Document violations.

d. The Corbett Settlement

The Corbett litigation was settled on May 17, 2000 (the "Corbett Settlement" or "Settlement"). The Settlement provided certain benefit enhancements to both active and retired SDCERS members. The Settlement provided that "each year, these payment[s] to the retired member[s] are contingent on SDCERS having sufficient Surplus Undistributed Earnings to pay them... to the extent these amounts are not paid in any year because there are insufficient surplus undistributed earnings, they will be carried forward as a contingent liability which will be paid in future years in which there are sufficient surplus undistributed earnings to pay them under the statute." *See* Corbett Settlement, Page 5.

Navigant Consulting has determined that "[t]he Corbett Settlement impacted SDCERS' actuarially determined liabilities and funding ratio." [Section VI.E.2.b] However, contrary to the actuary's recommendation, "SDCERS instructed the actuary not to include the benefit enhancements granted to the retired members under the Corbett Settlement [in his annual actuarial valuations] because they were deemed to be

contingent. However, the contingency appears to only address the timing of the payment, not if the benefits will be paid.”³¹ Navigant Consulting goes on to state with respect to the Corbett Settlement as follows:

In connection with the June 30, 2001 actuarial valuation, Mr. Roeder presented the valuation to the SDCERS Board on February 15, 2002. He noted that the Corbett benefits labeled “contingent” were not included in the valuation. The actuarial valuation stated “We have NOT included any Corbett contingent liabilities in the valuation. If we had included the value of such liabilities, estimated to be in the \$70-76 million range, the funded ratio would drop in the 2-2.5% range.”³²

Gabriel Roeder Smith calculated in its June 30, 2000 actuarial valuation that the System’s liabilities increased by approximately \$260.8 million as a result of the benefit enhancements under the Corbett settlement. Because the City’s contribution was in accordance with the terms of MP1, the City did not make additional contributions to fund these benefit enhancements. Based on information included in the June 30, 2001 actuarial valuation, Navigant Consulting estimated that the City’s contributions should have been increased by approximately \$17 million.³³ [Section VI.E.2]

The decision of the Board to go against actuarial advice and exclude “contingent” benefits from the valuations violates the requirement of Section 143 of the City Charter that the contributions to the Pension Fund be determined based on traditional actuarial principles and analysis. In addition, by permitting overpayments as determined in the September 20, 2005 audit report, the Board’s administration of the Corbett Settlement violated the “exclusive benefit” rule in Article XVI of the Constitution, §§ 17(a) and (b), and Article IX, of the City Charter § 145. Furthermore, permitting such overpayments violates the “definite written program” rule described in Chapter 1 of the Board Rules and Article XVI, of the Constitution, § 17(a).

e. Presidential Leave Benefit

i. Use of Improper Compensation

On October 21, 2002, the City Council passed a resolution permitting union presidents and former Police Officer Association union presidents to take into account both their

³¹ See *id.* It should also be noted that at the February 18, 2005 SDCERS’ Board meeting, the Board approved the inclusion of contingent benefits associated with the Corbett Settlement in the actuarial valuation. As a result, beginning with the June 30, 2005 actuarial valuation, the contingent portion of the Corbett Settlement will be included as a liability in the actuarial valuation. See Report, Section VI.E.2.b

³² Gabriel, Roeder, Smith, & Co., SDCERS, Annual Actuarial Valuation, June 30, 2001.

³³ This amount is calculated using the contribution rate associated with the Corbett contingent liabilities multiplied by the actuarial payroll and the ratio of the total Corbett liability to the Corbett contingent liabilities (1.1% x \$450 million x 3.5).

City salary and union salary in calculating their retirement benefits; however, the aggregate amount of salary considered could not exceed the current salary of the Labor Relations Manager. [Section VI.E.2; *See also* City Council resolution 297212] (This benefit is referred to herein as the Presidential Leave Benefit.) On October 24, 2003, the City Council entered into a separate agreement with Local 145 President, Ron Saathoff. The agreement permitted Mr. Saathoff to calculate his retirement benefits using his combined union and City salaries, and the agreement was retroactively effective to July 1, 2001. None of the other union presidents received salaries from both the City and the union; therefore, this special benefit applied only to Mr. Saathoff. [Section VI.F.8.ii.2]

Pursuant to the Presidential Leave Benefit program, Mr. Saathoff's combined union and City salary was required to be capped at an amount not to exceed that of the Labor Relations Manager for the fiscal years 2002 and 2003. In fact, however, Mr. Saathoff received retirement benefits calculated based on compensation in excess of that limit. Even his DROP benefits for those years were computed on the basis of his full combined salary. This overpayment in System benefits was not discovered until 2004, when the City's internal audit department conducted an audit of Mr. Saathoff's Presidential Leave Benefits. [Id]

The additional benefits or overpayments paid to Mr. Saathoff do not comport with benefits provided under the Plan Documents. Thus, the Presidential Leave Benefits paid to Mr. Saathoff violate the "exclusive benefit" rule in Article XVI, §§ 17(a) and (b) of the California Constitution, and Article IX, of the City Charter § 145. Furthermore, permitting such overpayments violates the "definite written program" rules described in Chapter 1 of the Board Rules and Article XVI, § 17(a) of the Constitution.

ii. Illegal Funding

Prior to March of 2004, after being elected as a union president a City employee was permitted to take an approved leave of absence, during which time his or her job could be held open pending his or her return. Alternatively, the employee could be released from his or her job to perform union duties, however, the City would continue to pay benefits for such individual. Beginning in 1989, if a union president went on a leave of absence from the City, he or she was allowed to continue making contribution to SDCERS while serving as a union president. And, since the president in such case would be receiving wages only from the union, the union paid all required contributions to SDCERS. (These contributions included both employer and employee contributions.) Beginning in 1997, all union presidents were permitted to continue contributions during their service as a union president, regardless of whether they were on a leave of absence or had been released from union duties, while still receiving paying benefits from the City. This practice was suspended in February of 2004, and, thus, SDCERS received no contributions from unions thereafter. [Id]

Under the Presidential Leave Benefit program, SDCERS accepted contributions from unions on behalf of union presidents. For the reasons explained below, the acceptance

of these contributions was a violation of the Code, and as such, subjects the Pension Fund to disqualification by the IRS.

As a governmental plan, pursuant to Code § 414(d), SDCERS must be “established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.” Notwithstanding the provisions of Code § 414(d), under certain circumstances union may either be considered to be a participating employer in a qualified plan or union officers may be considered participants in a plan that is provided such plan as a “collectively bargained plan.” Specifically, Code § 413(b) modifies the qualified plan rules for plans maintained pursuant to a collective bargaining agreement. Code § 413(b)(8) provides as follows:

EMPLOYEES OF LABOR UNIONS. — For purposes of this subsection, employees of employee representatives shall be treated as employees of an employer described in subsection (a)(1) if such representatives meet the requirements of §§ 401(a)(4) and 410 with respect to such employees.

Pursuant to Code § 413(a), the exception for collectively bargained plans is applicable only to “a plan maintained pursuant to an agreement which the Secretary of Labor finds to be a collective-bargaining agreement between employee representatives and one or more employers.....” The Preamble to City Council Resolution 297212, adopted on October 21, 2002, provides the City Council with the sole authority to establish the retirement benefits available under SDCERS. It also provides the Board with the sole authority to manage SDCERS, determine the rights to benefits under SDCERS and invest the Pension Fund. Notwithstanding the fact that the Presidential Leave Benefit program was developed as part of a negotiation process between the City Council and the unions, SDCERS was not established and is not maintained pursuant to a collective-bargaining agreement. Therefore, SDCERS does not satisfy the requirements of Code § 413(a) and, thus, is not eligible for the exception under Code § 413(b) permitting contributions from unions.

In conclusion, by accepting contributions from unions which are not government employers as described in Code § 414(d), the operation of the Presidential Leave Benefit program violated both the Code and the terms of the Plan Documents.

f. Retiree Healthcare Benefit and Code § 401(h) Compliance

i. Background

As a part of implementing the retiree healthcare provisions of MP 1, SDCERS and the City established a separate trust account within the pension fund. This separate account was later formally named and identified as the “401(h) Fund.” The City pays into this account the estimated cost of the retiree healthcare insurance premiums for each fiscal year, plus any additional reserve amounts. An equal amount is then transferred by

SDCERS to the City as a credit against the amount the City is obligated to contribute to the pension fund (the “actuarially required contribution” or “ARC”). This enables the City to fully recover the amount it contributes to SDCERS for retiree healthcare. The amount “returned” to the City purported comes from “surplus earnings,” defined by SDCERS as earnings in excess of the actuarial earnings assumption for a given year. Under the terms of the Plan Documents, all retiree healthcare premiums are to be paid from the 401(h) Fund.

The funding of retiree healthcare operates as follows:

1. Not later than May 31st of each year, the SDCERS administrator notifies the City Auditor and Comptroller of the estimated cost of health insurance premiums for the coming year, plus any additional amounts that are to be allocated to an account for health insurance reserves.
2. On July 1, the City Auditor and Comptroller transfer to SDCERS the annual employer contribution, less the amount necessary to fund retiree healthcare. The City contributes the amount necessary to pay retiree healthcare costs and fund the reserves to the "health insurance reserve" account.
3. After the outside auditor completes its annual Report of Changes in Undistributed Earnings, SDCERS transfers an amount from its “surplus earnings” into the Employer Contribution Reserve account, which is equal to the amount contributed by the City to the health insurance reserve account.
4. SDCERS then pays retiree healthcare costs from the 401(h) Fund, which is funds by transfer in excess earnings accrued under the System.

This funding “scheme” results in the City contributing to SDCERS only the amount necessary to meet the ARC obligation. No amount of the City's contribution to SDCERS is used to fund retiree healthcare costs. Thus, since at least 1982, the total cost attributable to retiree healthcare benefits has been borne by SDCERS, and is purportedly funded through current or reserved excess earnings. [Section VII]

ii. Analysis

In addition to the Code provisions discussed above, the San Diego Municipal Code (“Municipal Code”) provides SDCERS with the authority to establish and maintain a 401(h) account pursuant to all applicable Code requirements. Specifically, Article 4, Division 12, §24.1203(a) of the Municipal Code provides as follows:

- (a) All retiree health benefit payments by the 401(h) Fund will comply with all applicable federal laws, including § 401(h) of the Internal Revenue Code (“Code”). If there is a conflict between this Division and § 401(h) of the Code or regulations issued under that section, the **Code and regulations govern.** [Emphasis added]

Section 24.1203(b) of the Municipal Code provides for the establishment of a 401(h) fund as follows:

- (b) 401(h) Fund – Compliance with Applicable Provisions of the Code:
 - (1) All health benefits under this Division will be paid solely from the 401(h) Fund until the 401(h) Fund assets are exhausted.
 - (2) No health benefits provided under the 401(h) Fund may discriminate in favor of highly compensated employees.
 - (3) The 401(h) fund is a separate account solely for provided retiree health benefits. It is established and maintained by the Board to reflect the amounts the City contributed to pay retiree health benefits. The 401(h) Fund exists for record-keeping purposes only. Amounts credited to the 401(h) Fund may be invested with other Retirement System funds set aside for retirement purposes, without identifying which investments are allocated to each account. But earnings on each account must be allocated in a reasonable manner. (Emphasis Added).
 - (4) The City contributes to the 401(h) Fund solely to pay health insurance premiums under this Division. Contributions will be reasonable, ascertained, necessary and appropriate. Contributions will not exceed the amounts that would violate the Code requirements that health benefits be subordinate to the retirement benefits.
 - (5) When the City makes a contribution to the 401(h) Fund, it must designate in writing to the Board the portion of the contributions to be allocated to the 401(h) Fund for health benefits.
 - (6) No part of the 401(h) Fund may be used for any purpose other than paying health benefits under this Division. But, 401(h) Fund assets may be used to pay for necessary and appropriate administrative expenses related to retiree health benefits. (Emphasis Added.)
 - (7) Any amounts contributed to the 401(h) Fund that remain in the 401(h) Fund after all liabilities for retiree health benefits are satisfied, including benefits payable to existing Members in the future, will be returned to the City. The City will provide benefits to Health Eligible and Non Health Eligible Retirees equal to the returned amount.
 - (8) Section 24.1203 does not require separate accounts for Key employees because no member of the Retirement System is a key employee under the Code.

- (9) Assets attributable to any forfeitures of benefits payable by the 401(h) Fund will be used to reduce the City's contributions for retiree health benefits.

Section 24.1204 of the Municipal Code provides for the funding of the 401(h) Fund as follows:

The retiree health benefits described in this Division will be paid from the following sources of funds, in descending order of availability:

- (a) The 401(h) Fund, until exhausted, and
- (b) the City, directly, from any source available to it.

Finally, § 24.1502 (a) (5) of the Municipal Code provides that the "Surplus Undistributed Earnings" will be allocated to the 401(h) Fund after distributions made pursuant to §24.1502(a)(1)-(4) of the Municipal Code as follows:

(a) Surplus Undistributed Earnings are comprised of Investment Earnings Received for the previous fiscal year, less:

- (5) An amount, (the Division 12 amount), appropriate to provide health benefits to Health Eligible and Non Health Eligible Retirees as provided in Division 12 for the next fiscal year provided:
 - (A) in the next fiscal year, the City contributes to the 401(h) Fund no less than an equal amount which is designated to be used for retiree health benefits to be paid or reimbursed in the next fiscal year; and,
 - (B) to the extent the City makes a contribution to the 401(h) Fund for the next fiscal year, the Division 12 amount shall be treated as a portion of normal employer contributions paid to the Retirement System when the City so designates in accordance with § 24.1203(b)(5).

The SDCERS Board of Administration Trustee Handbook also provides for the establishment and maintenance of a 401(h) account. Specifically, Page 56 of the Trustee Handbook provides as follows:

Retiree health benefits for City retirees are currently paid on a "pay as you go" basis through a 401(h) Trust. They are not prefunded.

In a nutshell, the 401(h) trust-established under the Internal Revenue Code § 401(h) – is a separate account within the pension fund that is used to pay benefits for retired City employees. The 401(h) trust was created by Municipal Code § 24.123 solely for the purposes paying the retiree health premiums and benefits under the Municipal Code. **The 401(h) health trust is administered by the SDCERS Board and is funded with City contributions, which are not taxable to either the City or the plan Members.** [Emphasis added]

Under Code § 401(h), the general rule is that the account must be funded through by employer contributions made directly to the account. (Note that the Trustee Handbook requirement that the 401(h) Fund be “funded with City contributions is consistent with the Code in this respect.) However, there is an exception under Code § 420 permitting 401(h) accounts to be funded from excess assets of the pension plan. Thus, a threshold question in determining whether a pension plan sponsor can take advantage of the exception under Code § 420 is whether the pension plan, in fact, has excess assets as defined in the Code for purposes of funding the 401(h) account.

As explained above, the total cost of retiree healthcare benefits for the City has, since at least 1982, been borne by the pension assets of SDCERS. Under the exclusive benefit rule, as described under Code § 401(a), Article XV, § 17(a) of the Constitution and Article IX, § 45 of the City Charter, the pension assets of SDCERS must be used exclusively for paying retirement benefits for SDCERS participants and their beneficiaries. However, to the extent the pension fund has excess assets as described in Code § 420 and Municipal Code § 24.1502(a)(5), SDCERS may transfer that excess to the 401(h) Fund. Thus, in order for the SDCERS 401(h) Fund to comply with the Code § 41(h) requirements and, thus, sustain the pension funds qualified status under the Code, it must be established that SDCERS had, in fact, qualifying excess assets at all relevant times. Such assets would permit SDCERS to engage in a qualified transfer as defined in Code § 420(a).

With respect to SDCERS, the investigation has not identified any information supporting a finding that the System at anytime had excess assets, as required by Code § 420 and Municipal Code § 24.1502(a)(5). Furthermore, the investigation has not identified any information indicating that SDCERS, at anytime, engaged in an actuarial determination of the present value or future liability of retiree healthcare, as required under Code § 420(e)(2) and Article IV, Division 12, §§ 24.1203(a) and (b) of the Municipal Code. Rather, it appears that SDCERS simply estimated the annual cost of retiree healthcare by making projections based on historical data. Thus, since SDCERS has always used pension assets to fund the retiree healthcare program, and it appears unable to establish that it has at any time satisfied the Code § 420 exception permitting a transfer of pension assets for purposes of funding retiree healthcare costs, the fact that it used such assets to pay for healthcare is a violation of the exclusive benefit rule under Code § 401(a), Article XV of the Constitution, § 17(a) and Article IX, of the City Charter, § 45, the pension assets of SDCERS must be used exclusively for paying retirement benefits for SDCERS participants and their beneficiaries. In addition, the failure to administer SDCERS in accordance with its Plan Documents is a violation of Code § 401(a), and Treas. Reg. § 1.401-1(a)(2).

Thus, since at least 1982, SDCERS has paid the premiums for retiree healthcare benefits out of pension fund assets, in violation of the Code, the Constitution, the City Charter and the Municipal Code. This subjects the pension fund to disqualification by the IRS, in the event the IRS examines the pension fund and discovers this defect. Disqualification would result in the complete loss of all tax advantages currently available to SDCERS.

4. Conclusion Regarding Plan Asset Issue

For the reasons described above, MP1, MP2, the Corbett Settlement, the Presidential Leave Benefit program and the retiree healthcare program all result in failures to comply with the Code and the terms of the Plan Documents. These failures, in turn, result in “exclusive benefit” and/or “definite written program” violations of the requirements described in the Constitution, the City Charter and Chapter 1 of the Board Rules. In addition, the failures result in corresponding violations of the tax qualification rules under Code §401(a) and Treas. Reg. § 1.401-1(a)(2).

Under the IRS’ Employee Plans Compliance Resolution System (EPCRS), the violations of Code § 401(a) amount to Qualification Failures, as that term is defined in § 5.01(2) of Rev. Proc. 2003-44. In addition, because the specific Qualification Failures involve failures to follow the terms of the Plan Documents, they amount to Operational Failures, as described in § 5.01(2)(b) of Rev. Proc. 2003-44. Finally, the excess benefits paid out under the Corbett Settlement and provided to Mr. Saathoff under the Presidential Leave Benefit program for 2002 and 2003 amount to “overpayments,” as described in §5.01(6) of Rev. Proc. 2003-44.

If the IRS were to commence an examination of the Retirement System and discover these defects, it could propose disqualification of the Pension Fund. Since SDCERS is a governmental plan under Code §§ 401(a) and 414(d), the typical consequences (loss of tax deductions and tax on trust earnings) would not apply. However, plan disqualification could result in Members of the Retirement System being taxed on their vested accrued benefits. This additional tax has the potential to be substantial, particularly to the extent interest and penalties accumulate on prior tax years.

Navigant Consulting’s investigation has determined that at least three SDCERS employees have been charged with primary responsibility for administering the 401(h) Fund, from which all retiree health benefits are to be paid. *See* Municipal Code §§ 24.1203(a) and (b), 24.1204, 24.1502(a)(5) and Trustee Handbook page 56. In addition, during peak work periods, SDCERS has used temporary staffing for this purpose. The administration of the 401(h) Fund includes processing claims, paying health program premiums, maintaining eligibility records and processing plan enrollment changes. [Section VI.D.4.a.]

The cost of administering the 401(h) Fund was to have been funded entirely from “Surplus Undistributed Earnings.” [*Id.*] Thus, in determining the City’s annual required contribution, it should not have been necessary to take into account the cost of operating the 401(h) Fund and, in fact, SDCERS has not taken this cost into account in preparing its annual valuations and determining the annual required contribution. [*Id.*] As indicated above, however, Navigant Consulting’s investigation has not identified any information supporting a finding that SDCERS at anytime had excess assets

available to fund the 401(h) Fund. Thus, the cost of administering the 401(h) Fund program has at all times, necessarily, been borne by pension assets.³⁴

As discussed above, the use of pension assets for non-pension plan purposes is a violation of the “exclusive benefit rule,” as set forth in Code § 401(a) and related regulations, Article XVI, Section 17 of the Constitution and Article IX of the City Charter. In addition, funding the 401(h) Fund program with pension assets, rather than “Surplus Undistributed Earnings,” is contrary to what is required by the Plan Documents. This results in a violation of the “definite written program” requirements described in Code, related regulations and the Plan Documents. These violations subject the Pension Fund to disqualification.

In addition, since the City is responsible for all SDCERS costs which cannot be covered by Surplus Undistributed Earnings, the use of SDCERS staff and, thus, pension assets to pay for the cost of operating the 401(h) Fund program “relieved” the City of that cost obligation. As a result, SDCERS made “part of its services available [to the City] on a preferential basis” as proscribed by Code § 503(b)(3). In addition, it could be reasonably argued that SDCERS advanced costs or extended credit to the City with respect to the expenses of operating the 401(h) Fund program and, thus, made an unsecured loan to the City in violation of Code § 503(b)(1). In any event, it is clear that in bearing the cost of the 401(h) Fund program, SDCERS engaged in a prohibited transaction under Code § 503(b). These violations subject the Pension Fund to disqualification.

D. Other Issues – Employment Law Issues

The following discussion was prepared by John Adler, Esq. of Littler Mendelson, P.C., San Diego, California:

First Issue Presented

Did Retirement Administrator Grissom have an obligation under State employment laws to inform the SDCERS Board, or some other person or entity, about the substantial pension benefit increase under MP 2 to then-Board member Saathoff?

Conclusion on First Issue

Yes. Mr. Grissom was required under law to acquire such knowledge as was necessary for him to be fully informed regarding the facts and circumstances of Mr. Saathoff’s benefit. Furthermore, Mr. Grissom had a legal duty to fully disclose this information to the Board. The question of whether Mr. Grissom breached his duty under the law to properly inform and/or advise the Board of Mr. Saathoff’s benefit increase under MP 2 will ultimately be resolved by the courts.

³⁴ *id.*

Discussion of First Issue

As the SDCERS Retirement Administrator, Larry Grissom was required by law to have actual knowledge of the terms and conditions of all proposals concerning benefit changes presented to the Board, including those set forth in MP2. Mr. Grissom's position included oversight responsibilities of the Financial & Technical Services Division, and included direct and comprehensive communications with the Board of Administration and its members. Thus, it appears reasonable to assume that Mr. Grissom either knew or should have known of the enhanced benefits provided to Mr. Saathoff within MP2.

Section 225 of Article XIV of The City of San Diego Charter is entitled "Mandatory Disclosure of Business Interests" and states as follows:

"No right, title or interest in the City's real or personal property, nor any right, title or interest arising out of a contract, or lease, may be granted or bargained pursuant to the City's general municipal powers or otherwise, nor any franchise, right or privilege may be granted pursuant to Section 103 or 103.1 of this Charter, unless the person applying or bargaining therefor makes a full and complete disclosure of the name and identity of any and all persons directly or indirectly involved in the application or proposed transaction and the precise nature of all interests of all persons therein.

"Any transfer of rights, privileges or obligations arising from a franchise, right or privilege granted under Charter Section 103 or 103.1, or any transfer of any right, title or interest in the City's real or personal property, or any right, title or interest arising out of a contract, or lease, which may be granted or bargained pursuant to the City's general municipal powers or otherwise, shall also require a full and complete disclosure as set forth above.

"Failure to fully disclose all of the information enumerated above shall be grounds for denial of any application or proposed transaction or transfer and may result in forfeiture of any and all rights and privileges that have been granted heretofore. For purposes of this Charter section, the term "person" means any natural person, joint venture, joint stock company, partnership, association, firm, club, company, corporation, business trust, organization or entity." (Addition voted 06-02-1992; effective 07-13-1992.)

Thus, the Charter provides that no "right, title or interest arising out of contract" may be "granted or bargained" unless the persons applying therefore make "a full and complete disclosure" of all persons involved "in the application or proposed transaction and the precise nature of all interests of all persons therein." Furthermore, the Charter provides

that any failure to make a “full and complete disclosure of all the information” shall be grounds for “denial” or “forfeiture.”

California statutes provide an employer such as the SDCERS with a basis for both expecting and demanding such a disclosure. Labor Code section 2854 states:

“One who, for a good consideration, agrees to serve another, shall perform the service, and shall use ordinary care and diligence therein, so long as he is thus employed.”

In addition, an employee must also:

(1) exercise a reasonable degree of skill, unless his employer has notice, before employing him, of his want of skill (Labor Code section 2858);

(2) use such skill as he possesses, so far as the same is required, for the service specified (Labor Code section 2859);

(3) substantially comply with all the directions of his employer concerning the service on which he is engaged, except where such obedience is impossible or unlawful, or would impose new and unreasonable burdens on the employee (Labor Code §2856);

(4) perform his service in conformity to the usage of the place of performance, unless otherwise directed by his employer, or unless it is impracticable or manifestly injurious to his employer to do so (Labor Code §2857); and

(5) exercise ordinary care in the selection of a substitute, when the employee is expressly authorized to employ a substitute (Labor Code §2864).

Based on the forgoing discussion, it is the law in California that an employee’s improper performance of duties, whether by intent or by negligence, presents issues of liability of the employee for the failure to properly perform. In that regard, SDCERS had a right to expect Mr. Grissom to acquire all necessary information and make those disclosures necessary to put the Board in a position where it could knowledgeably act on matters Mr. Grissom either personally presented to the Board, or which were presented by others to the Board, in the presence of and/or with the consent of Mr. Grissom. MP2, and all of its provisions, would fall within such matters.

With respect to fraud and/or misrepresentation, in California fraud can be “either actual or constructive.” (Civil Code §1571.) Specifically, California Civil Code §§1572 and 1573 state as follows:

“1572. Actual fraud, within the meaning of this Chapter, consists in any of the following acts, committed by a party to the contract, or with his connivance, with intent to deceive another party thereto, or to induce him to enter into the contract:

1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
2. The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true;
3. The suppression of that which is true, by one having knowledge or belief of the fact;
4. A promise made without any intention of performing it; or,
5. Any other act fitted to deceive.

“1573. Constructive fraud consists:

1. In any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him; or,
2. In any such act or omission as the law specially declares to be fraudulent, without respect to actual fraud.”

Thus, actual fraud is found where there is a suggestion of a fact, of that which is not true, by one who does not believe it to be true; it is also found within a positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true; it is also found within “the suppression of that which is true, by one having knowledge or belief of the fact”; and it is any other act “fitted to deceive.”

Constructive fraud requires a breach of duty resulting in the misleading of another to his prejudice. Within the Labor Code, there is inherent a requirement that the agent, servant or employee not commit fraud, either actual or constructive, as to his or her employer. Further support for such a position is found within California Civil Code §§1709 and 1710 which address deceit. The scope of these statutory provisions, much like the fraud provisions noted above, extends to suggestions, assertions, and to the suppression of facts. As to this latter point, Civil Code §1710, subsection 3 states: “the suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact” commits the legally-actionable tort of deceit.

The City of San Diego Charter at Article XIV, §225, is entitled “Mandatory Disclosure of Business Interests” and is instructive. Within that section no “right, title or interest arising out of contract” may be “granted or bargained” unless the persons applying therefore make “a full and complete disclosure” of all persons involved “in the application or proposed transaction and the precise nature of all interests of all persons

therein.” Paragraph two of that section presents a further basis for requiring “full and complete disclosure.”

California statutes provide an employer such as the SDCERS with a basis for both expecting and demanding such a disclosure. Labor Code §2854 states:

“One who, for a good consideration, agrees to serve another, shall perform the service, and shall use ordinary care and diligence therein, so long as he is thus employed.”

In addition, an employee must also:

- (1) exercise a reasonable degree of skill, unless his employer has notice, before employing him, of his want of skill (Labor Code §2858);
- (2) use such skill as he possesses, so far as the same is required, for the service specified (Labor Code §2859);
- (3) substantially comply with all the directions of his employer concerning the service on which he is engaged, except where such obedience is impossible or unlawful, or would impose new and unreasonable burdens on the employee (Labor Code §2856);
- (4) perform his service in conformity to the usage of the place of performance, unless otherwise directed by his employer, or unless it is impracticable or manifestly injurious to his employer to do so (Labor Code §2857); and
- (5) exercise ordinary care in the selection of a substitute, when the employee is expressly authorized to employ a substitute (Labor Code §2864).

From the above, therefore, it is recognized in California that an employee’s improper performance of duties, whether by intent or by negligence, presents issues of liability of the employee for the failure to properly perform. In that regard, the SDCERS had a right to expect Mr. Grissom to acquire the necessary information and make those disclosures necessary in order that the Board knowledgeably and intelligently act on matters which Mr. Grissom either personally presented to the Board, or which were presented by others to the Board, in the presence of and/or with the consent of Mr. Grissom. MP2, and all of its provisions, would fall within such matters.

As to the fraud and/or misrepresentation requirement, in California fraud can be “either actual or constructive.” (Civil Code section 1571.) Actual fraud is found where there is a suggestion of a fact, of that which is not true, by one who does not believe it to be true; it is also found within a positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true; it is

also found within “the suppression of that which is true, by one having knowledge or belief of the fact”; and it is any other act “fitted to deceive.” (California Civil Code §1572.)

Constructive fraud requires a breach of duty resulting in the misleading of another to his prejudice. Within the “faithful servant” requirements of the Labor Code, there is inherent a requirement that the agent, servant or employee not commit fraud, either actual or constructive, as to his or her employer. Further support for such a position is found within California Civil Code §§1709 and 1710 which address deceit. The scope of these statutory provisions, much like the fraud provisions noted above, extends to suggestions, assertions, and to the suppression of facts. As to this latter point, Civil Code §1710, subsection 3 states: “the suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact” commits the legally-actionable tort of deceit.

Both the California Civil Code and the California Labor Code set forth various obligations imposed by law on employees, but none discuss a duty of disclosure of financial inaccuracies or wrongdoing, either actual or suspected. The closest any of these statutes come to providing a basis for such an argument is contained in the duty of loyalty provisions within the Labor Code. Nevertheless, none appear to cover the circumstances addressed herein and to my knowledge no judicial decision has ever extended or applied coverage to such circumstances. Labor Code §2856 requires an employee to

“substantially comply with all the directions of his employer concerning the service on which he is engaged, except where such obedience is impossible or unlawful, or would impose new and unreasonable burdens upon the employee.”

Furthermore, under Labor Code §2858, “An employee is bound to exercise a reasonable degree of skill,” and under Labor Code §2859, “An employee is always bound to use such skill as he possesses, so far as the same is required, for the service specified.”

Finally, under Labor Code §2865, “An employee who is guilty of a culpable degree of negligence is liable to his employer for the damage thereby caused to the employer.”

Examining these statutes in concert, an argument can be made that staff members having knowledge of inaccurate disclosures, and who do nothing, are not complying with the directions of the employer, are not performing their jobs properly, and are conducting themselves in a negligent manner with conduct falling below a standard of care, by allowing such actions to occur.

This argument can be bolstered by reference to any governing policies and procedures, or job descriptions, that would create a factual basis for requiring employees to take

action if they knew of inaccurate disclosures. References in those governing documents may relate to tasks that require them to accurately and completely represent the financial circumstances of the employer. This approach is addressed more fully below.

An additional argument might be presented using Civil Code §1708, which provides,

“Every person is bound, without contract, to abstain from injuring the person or property of another, or infringing upon any of his or her rights.”

Civil Code §§1709, 1710 and 1711 provide additional statutory support prohibiting deceit, with particular regard in Section 1711 to deceit to defraud the public. Returning, however, to Section 1708, it would be logical to argue that SDCERS staff members would know that inaccurate disclosures had the likelihood of injuring or harming the property of the retirees or prospective retirees, namely their retirement benefits. The duty provided in Civil Code §1708 is a requirement that the employee “abstain from injuring,” which might require an affirmative report of wrongdoing, rather than allowing silence or inaction to be acceptable if the resulting circumstances caused financial injury.

Support for an affirmative duty might also be drawn from California Penal Code §424, although to my knowledge it has never been used for such a purpose. This criminal statute punishes any

“person charged with the receipt, safekeeping, transfer, or disbursement of public moneys, who either:

3. Knowingly keeps any false account, or makes any false entry or erasure in any account of or relating to the same; or,
4. Fraudulently alters, falsifies, conceals, destroys, or obliterates any account ...”

The argument might be made that a staff member having knowledge of inaccurate disclosures and who fails to act to correct those disclosures is knowingly keeping a false account and/or has fraudulently acted to conceal the account, both of which might violate Penal Code §424.

Under certain circumstances, support for an affirmative duty to report wrongdoing might be found in California Government Code §8314, which makes it unlawful for any state or local employee or consultant to use public resources for personal or other purposes not authorized by law. As defined in this statute, “personal purpose” includes “personal enjoyment, private gain or advantage, or an outside endeavor not related to state business.” Also, within this statute, “public resources” includes the “funds” of the

state or any local agency. The statute provides for a civil penalty for any intentional or negligent violation of the section within Government Code §8314(c)(1) with a four-year statute of limitations (Section 8314(c)(3)).

Finally, although this inquiry was directed in the context of California employment laws, I would be remiss if I did not mention federal securities laws that may be implicated by the bond offering documents. In recognizing a duty to refrain from making misleading statements, a failure to disclose inaccurate disclosures rising to the level of “material facts” might cause the Board, or its designated officials, to be in a position whereby they assert false statements concerning the condition of the fund. This portion of the analysis will necessarily need additional inquiry and analysis, if it is determined to be warranted.

California courts have recognized the duty of loyalty required of employees, but judicial recognition of this obligation has usually taken place within the context of a fraud/embezzlement claim or an unfair competition claim. In both contexts, the employees sought to be held liable under a duty of loyalty analysis have directly engaged in wrongful acts for their own financial benefit. One prominent example is found in Fowler v. Varian Associates, Inc., 196 Cal. App. 3d 34 (1987). In Fowler, the duty of loyalty was held breached when the employee refused to provide his employer with knowledge about a competitor because the employee had engaged in independent business dealings with that competitor. The court recognized that Fowler’s participation in activities for both employers, competitors of each other, was inconsistent with his duty to prefer his employer’s interests over those of its competitors. Id. at 42.

Stokes v. Dole Nut Co.,⁴¹ Cal. App. 4th 285 (1995), also addressed the duty of loyalty within the context of an existing employee’s unfair competition activities. Of interest to our analysis is the reference in Stokes to the following principle: “the significant inquiry in each situation is whether the officer’s acts or omissions constitute a breach under the general principles applicable to the performance of his trust.” (Id. at 294, citing, Bancroft-Whitney Co. v. Glen, 64 Cal.2d 327, 347 (1966).

Stokes went on to comment,

“we have found no authority for the proposition that to constitute cause for termination an employee’s conduct must amount to a criminal or civil wrong. Rather, as we have noted, cause for termination must be a fair and honest cause or reason under the particular circumstances of the case and with due deference to the legitimate exercise of managerial discretion. In applying this standard, it would be anomalous to hold that an employer must wait to take action until an employee actually causes it tortious injury. . . Instead, we hold only that actions short of tortious misbehavior may support termination when considered in the circumstances of the particular case involved.” Id. at 294-295.

Finally, as to the issue of the duty of loyalty, J. C. Peacock, Inc. v. Hasko, 196 Cal. App. 2d 353 (1961) may be instructive. In its discussion of the duty of loyalty, this decision referenced some secondary authorities and held:

“Accordingly, fraud, bad faith, gross misconduct, gross mismanagement, or a failure to follow instructions on the part of the agent forfeits his right to compensation for his services. For example, where an agent is guilty of concealment or nondisclosure of material facts relating to the subject matter of the agency, he forfeits his right to compensation.” Id. at 358.

Hasko addressed the duty of loyalty in the context of a principal-agent relationship in a case involving an employee’s disloyalty claim and the employee’s efforts to recover a bonus. Citing 4 Williston on Contracts, at Section 1022, the opinion stated:

“The duty of fidelity to his employment imposes on the employee not simply the positive duty of reasonably skillful performance of the work intrusted to him, but the negative duty of refraining from deception and from entering into relations giving him an interest inconsistent with that of the employer. Thus, deceptive and fraudulent statements or conduct not only renders the employee liable, but justifies his discharge.” Id. at 358.

This analysis, obviously, appears in the context of a “contractual” relationship and does not directly rely upon any statute or cite any California precedent.

Finally, any attempt to use a “breach of fiduciary duty” analysis to require this affirmative disclosure of financial wrongdoing by staff members would also likely fail, absent strong facts supporting a contrary holding. Although a fiduciary duty might be found to extend to officers and directors, it is not a duty typically found to apply to staff members, as presented in the questions posed. In California, there is no “special relationship” between employers and employees that gives rise to anything beyond contractual remedies, (at least) in the wrongful discharge context.” Foley v. Interactive Data Corp. 47 Cal. 3d 654, 690-693 (1988). It is my opinion that California courts would be unwilling to find that a fiduciary relationship exists between the staff members and SDCERS, sufficient to support an approach based on this duty.

This opinion is further supported by wrongful termination litigation in California. In that regard, if there was a recognized public policy obligation for an employee to report financial inaccuracies or wrongdoing, arguably every such report rendered in good faith would present a basis for a retaliatory discharge — violation of fundamental public policy tort claim. Case law in California shows that is not the case. The reporting of unlawful acts which become actionable in California must be tethered to a statute or regulation making such retaliation against the whistleblower illegal. In this regard,

California courts have recognized “the broad public policy interest in encouraging workplace whistleblowers to report unlawful acts without fearing retaliation.” Green v. Ralee Engineering Co. 19 Cal. 4th 66, 77 (1998).

Nevertheless, there is a significant difference between a public policy that protects whistleblowers and even a public policy interest in encouraging whistleblowers, as compared to the finding of an affirmative duty to report wrongdoing and thus a public policy requirement that an employee become a whistleblower. In short, California has not regulated this area to require, or mandate, the whistleblowing activity, in contrast to, for example, known or suspected abuse of a child or dependent adult. Protection is provided, under certain circumstances, for those who choose to so act, but there is no statutory support requiring any such action by employees when financial improprieties are in issue.

Finally, California Labor Code §1102.5 prohibits an employer from implementing or enforcing a policy “preventing an employee from disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe” that there has been a violation of law. Labor Code §1102.5(a). In subsections (b), (c), and (d), the statute prohibits retaliation for disclosing information. This code section was enacted in 1984 and most recently amended in 2003. In the 2003 amendments, the Statutory Notes provide:

“The Legislature finds and declares that it is the public policy of the State of California to encourage employees to notify an appropriate government or law enforcement agency when they have reason to believe their employer is violating laws enacted for the protection of corporate shareholders, investors, employees and the general public.”

Thus, it remains consistently the policy position of statutory law in California that although the reporting of financial wrongdoing by employees is encouraged and protected, it is not mandated by statute, although it might be required under the particular circumstances of an employee’s position. Thus, the failure to act to report wrongdoing does not generally implicate a statutory violation but, rather, becomes a potential violation of the employer’s own policies, or a violation of an employee’s own established or implied duties and responsibilities. Upon such a basis, an employer may legitimately find that the employee has failed to comply with policies, or failed to discharge the required duties and responsibilities, where an employee does not report wrongdoing yet holds a job that requires him/her to do so. Such a failure to act would be job or employer-specific and, essentially, contractual in nature.

Second Issue Presented

What duty, if any, would SDCERS staff members have if they had knowledge of any inaccurate disclosures in the City's financial statements or bond offering documents? And what duty, if any, did the SDCERS staff have to share material facts with the Board?

Conclusions on Second Issue

California law does not set forth any specific affirmative duty on the part of an employee, either public or private, to report financial inaccuracies or wrongdoing to his/her employer or to governmental authorities. California does, however, have a strong public policy encouraging and protecting public employee whistleblowers, but it does not extend to any mandatory reporting of financial matters.

Discussion of Second Issue

A. Statutory Rules

Both the California Civil Code and the California Labor Code set forth various obligations imposed by law on employees, but none discuss a duty of disclosure of financial inaccuracies or wrongdoing, either actual or suspected. The closest any of these statutes come to providing a basis for such an argument is contained in the duty of loyalty provisions within the Labor Code. Specifically, Labor Code §2856 requires an employee to

“substantially comply with all the directions of his employer concerning the service on which he is engaged, except where such obedience is impossible or unlawful, or would impose new and unreasonable burdens upon the employee.”

In addition, under Labor Code §2858 “[a]n employee is bound to exercise a reasonable degree of skill,” and under Labor Code Section 2859 “[a] employee is always bound to use such skill as he possesses, so far as the same is required, for the service specified.” Finally, under Labor Code §2865, “[a] employee who is guilty of a culpable degree of negligence is liable to his employer for the damage thereby caused to the employer.”

Examining these statutes in concert, it could be argued that any SDCERS staff members who had knowledge of inaccurate financial disclosures and did nothing to correct the situation or otherwise bring it to light, failed to comply with SDCERS' directions and, thus, perform their jobs properly. If proven true, such conduct falls below the standard of care for SDCERS employment and would support a claim of negligence. Additional support for this argument can be found in California Civil Code §1708, which provides

that “[e]very person is bound, without contract, to abstain from injuring the person or property of another, or infringing upon any of his or her rights.”

California Civil Code §§1709, 1710 and 1711 provide additional statutory support prohibiting deceit by government workers and, in particular, deceit to defraud the public. Those code sections provide as follows:

1709. One who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers.

1710. A deceit, within the meaning of the last section, is either:

1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
2. The assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true;
3. The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact; or,
4. A promise, made without any intention of performing it.

1710.1. Any person who, with intent to defraud, sells or disposes of a radio, piano, phonograph, sewing machine, washing machine, typewriter, adding machine, comptometer, bicycle, firearm, safe, vacuum cleaner, dictaphone, watch, watch movement, watchcase, or any other mechanical or electrical device, appliance, contrivance, material, piece of apparatus or equipment, from which the manufacturer's nameplate, serial number or any other distinguishing number or identification mark has been removed, defaced, covered, altered or destroyed, is civilly liable to the manufacturer in the sum of five hundred dollars (\$500) per transaction and civilly liable to the purchaser for treble the actual damages sustained by the purchaser.

This section does not apply to those cases or instances where any of the changes or alterations enumerated in this section have been customarily made or done as an established practice in the ordinary and regular conduct of business by the original manufacturer or his duly appointed direct representative or under specific authorization from the original manufacturer.

1710.2. (a) No cause of action arises against an owner of real property or his or her agent, or any agent of a transferee of real property, for the failure to disclose to the transferee the occurrence of an occupant's death upon the real property or the manner of death where the death has occurred more than three years prior to the date the transferee offers to purchase, lease, or rent the real property, or that

an occupant of that property was afflicted with, or died from, Human T-Lymphotropic Virus Type III/Lymphadenopathy-Associated Virus. As used in this section, "agent" includes any person licensed pursuant to Part 1 (commencing with Section 10000) of Division 4 of the Business and Professions Code. As used in this section, "transferee" includes a purchaser, lessee, or renter of real property.

(b) It is the intention of the Legislature to occupy the field of regulation of disclosure related to deaths occurring upon real property and of AIDS in situations affecting the transfer of real property or any estate or interest in real property.

(c) This section shall not be construed to alter the law relating to disclosure pertaining to any other physical or mental condition or disease, and this section shall not relieve any owner or agent of any obligation to disclose the physical condition of the premises.

(d) Nothing in this section shall be construed to immunize an owner or his or her agent from making an intentional misrepresentation in response to a direct inquiry from a transferee or a prospective transferee of real property, concerning deaths on the real property.

1711. One who practices a deceit with intent to defraud the public, or a particular class of persons, is deemed to have intended to defraud every individual in that class, who is actually misled by the deceit.

It is reasonable to assume that certain SDCERS staff knew or should have known that inaccurate disclosures in financial statements could adversely affect SDCERS current and former participants. For any such employee, California Civil Code §1708 requires him or her to "abstain from injuring," which likely requires an affirmative report of wrongdoing and, thus, prohibits silence or inaction under these circumstances. In addition, California Penal Code §424 provides, in relevant part, as follows:

"(a) Each officer of this state, or of any county, city, town, or district of this state, and every other person charged with the receipt, safekeeping, transfer, or disbursement of public moneys, who either:

1. Without authority of law, appropriates the same, or any portion thereof, to his or her own use, or to the use of another; or,
2. Loans the same or any portion thereof; makes any profit out of, or uses the same for any purpose not authorized by law; or,

3. Knowingly keeps any false account, or makes any false entry or erasure in any account of or relating to the same; or,
4. Fraudulently alters, falsifies, conceals, destroys, or obliterates any account....”

Thus, a staff member having knowledge of inaccurate disclosures and who fails to act to correct those disclosures “knowingly keeping a false account” and/or has fraudulently acted to conceal the account, both of which are independently sufficient to violate Penal Code §424.

With respect to an affirmative duty to report wrongdoing, California Government Code §8314 states, in relevant part, as follows:

8314. (a) It is unlawful for any elected state or local officer, including any state or local appointee, employee, or consultant, to use or permit others to use public resources for a campaign activity, or personal or other purposes which are not authorized by law.

(b) For purposes of this section:

(1) "Personal purpose" means those activities the purpose of which is for personal enjoyment, private gain or advantage, or an outside endeavor not related to state business. "Personal purpose" does not include the incidental and minimal use of public resources, such as equipment or office space, for personal purposes, including an occasional telephone call . . .

(3) "Public resources" means any property or asset owned by the state or any local agency, including, but not limited to, land, buildings, facilities, funds, equipment, supplies, telephones, computers, vehicles, travel, and state-compensated time.

(4) "Use" means a use of public resources which is substantial enough to result in a gain or advantage to the user or a loss to the state or any local agency for which a monetary value may be estimated.

(c) (1) Any person who intentionally or negligently violates this section is liable for a civil penalty not to exceed one thousand dollars (\$1,000) for each day on which a violation occurs, plus three times the value of the unlawful use of public resources. The penalty shall be assessed and recovered in a civil action brought in the name of the people of the State of California by the Attorney General or by any district attorney or any city attorney of a city having a population in excess

of 750,000. If two or more persons are responsible for any violation, they shall be jointly and severally liable for the penalty . . .

(3) No civil action alleging a violation of this section may be commenced more than four years after the date the alleged violation occurred . . .

Thus, Government Code §8314 makes it unlawful for any state or local employee or consultant to use public resources for personal or other purposes not authorized by law. As defined in this statute, “personal purpose” includes “personal enjoyment, private gain or advantage, or an outside endeavor not related to state business.” Also, within this statute, “public resources” includes the “funds” of the state or any local agency. The statute provides for a civil penalty for any intentional or negligent violation of the section within Government Code §8314(c)(1) with a four-year statute of limitations (Section 8314(c)(3)).

V. RECOMMENDATIONS

Based on the findings made by Navigant Consulting and the legal conclusions stated above, we make the following recommendations:

1. **Formal Fiduciary Training for Board Members.** The 2005 changes in the membership of the Board made by Proposition H have significantly improved the governance of SDCERS by creating a truly independent Board. However, even independent Board members may not be fully aware of their responsibilities. The Board members are fiduciaries whose conduct is regulated by the California Constitution, Government Code, City Charter and Municipal Code. In addition, they have specified duties with respect to actuarial matters. It is apparent that the members of the Board who served at the time of MP 1 and MP 2 did not fully understand their fiduciary and funding responsibilities. We recommend that each Board member be required to attend formal fiduciary training of their duties under each of those laws.
2. **Actuarial Reports and Reporting.** We recommend that the following requirements be added to the actuary’s duties:
 - The SDCERS actuary should provide a written Report each year in conjunction with its actuarial valuation which discusses the actuarial requirements under each of the Constitution, State and Municipal law and reports whether each of those laws has been complied with for the preceding year. A copy of that Report should concurrently be delivered to the Mayor and the City Council and posted on the SDCERS website for public awareness. This Report should also provide for projected assets, liabilities and contributions based on the assumptions then being used by

the Retirement System. (The Report should include any benefit increases which have been granted and become effective during the five year period).

- The Board rules should be amended to require that the actuary deliver this Report and comment on his conclusions in open session.
- Once the actuary has completed the annual valuation and the Board has approved the actuarially required contribution (ARC) and the Board has approved that, The Board should render a formal billing to the City for that amount. The bill should be presented no later than January 31 of each year.

3. Board Membership. We recommend the following with respect to Board membership:

- The Board recommend to the Mayor and the City Council that the Municipal Code, or if necessary, the Charter, be amended to provide that a Board Member may not resign until a qualified successor has been selected and agreed to serve. This would codify generally accepted principles for trustees and other fiduciaries of trusts and would protect the Board and SDCERS from the problems encountered in mid-2005 when the Board had difficulty in achieving a quorum.
- The Board recommend that the Municipal Code, or if necessary, the Charter be amended to create a commission to identify and recommend qualified Board candidates to the Mayor to ensure that only qualified and independent individuals serve on the Board.
- While Proposition H strengthened the independence of the Board, in the past there continued to be threats to that independence. For example, during 2005, a number of Board members, appointed as a result of Proposition H, resigned, at least partially because of litigation and threats by City officials. This type of turnover threatens the independence of the Board. Therefore, the Board should recommend to the City that it amend the Municipal Code, or if necessary, the Charter, to comply with the express intent of Prop. 162 as stated in the following "finding":

"The integrity of our public pension systems demands that safeguards be instituted to prevent political 'packing' of retirement boards, and encroachment upon the sole and exclusive fiduciary powers or infringement upon the actuarial duties of those retirement boards."

4. Quid Pro Quo Arrangements. We have two recommendations:

- The Board Rules should provide that the Board may not be involved in the setting of benefits or engage in any discussions that condition the amount

of funding on the setting of benefits. The setting of benefits can only be done by the City Council amending the Municipal Code.

- The Board should also recommend to the City Council that it amend the Municipal Code (or perhaps send to the voters a proposal to amend the City Charter) to preclude the City from linking benefit increases to actions by the Board.

5. Board Operations. We have the following recommendations:

- The Board should require that the SDCERS general counsel report directly to the Board rather than to the Retirement Administrator. This is consistent with the April 8, 1997 Agreement for Legal Services between the City Attorney and SDCERS.
- The Board should conduct formal annual reviews of the Retirement Administrator and General Counsel and annually set their compensation.

6. SDCERS General Counsel. The April 8, 1997 Agreement for Legal Services between the City Attorney and SDCERS recognized the importance of SDCERS having separate legal counsel because of potential conflicts that exist between the City and SDCERS. Indeed, at least a substantial conflict exists currently, inasmuch as the City is a debtor to the Retirement System and SDCERS is a creditor of the City related to the funding shortfalls created by MP 1 and MP 2. Because of this debtor-creditor relationship, the same attorney should not represent both parties. Further, if the Board does not have separate counsel, this would create a situation that Proposition 162 was intended to prevent, i.e., the exercise of political influence over the fiduciary decisions of the Board. Therefore, we recommend that SDCERS continue to have the General Counsel position filled by its employee.

7. Current Litigation. It is essential for the Board to know whether the benefits agreed to by the City and its unions in connection with MP 1 and MP 2 are legal so that it knows how much to be paid out in benefits to retirees. As a result, we believe it is essential for SDCERS to continue to pursue its declaratory relief action against the City related to the propriety of benefits.

8. MP 1 and MP 2 Funding Shortfalls. As noted in other parts of the Report, MP 1 and MP 2 resulted in shortfalls in the actuarially required funding of the Retirement System. We also indicate that the Board has a fiduciary obligation to collect that funding shortfall but note that under GASB rules, the unfunded amount may be amortized over a period of up to 30 years. We recommend that the Board analyze, with the assistance of its actuary and independent counsel, the best way to recoup that shortfall, and if it is permitted to be amortized, the period over which such amortization be permitted. In addition, the Board should analyze the likelihood of the City entering into an arrangement under the U. S. Bankruptcy

Code; and if that is deemed likely, determine what steps to protect the Retirement system and its Members. For example, in the settlement of the Gleason litigation, SDCERS received security interests in real property to support the City's promise to pay contributions.

9. Tax Qualification Issues. In order to correct the tax qualification failures noted in the Legal Conclusions Section of the Report, we recommend that SDCERS file an application with the IRS under the remedial correction program to negotiate and make retroactive correction of these failures. To the extent that correction of the failures requires the payment of a correction amount from the City, the Board should initiate discussions with the City for the payment of those amounts.
10. Assessment of Other Issues. To the extent legal conclusions were not expressed in the Report arising out of facts developed by Navigant Consulting in its investigation, the Board should consider what steps, if any, should be taken with respect thereto.

Definition of Key Terms

Actuarial Accrued Liability – The present value of all benefits for covered employees and annuitants less the present value of future contributions.

Amortization – Allocation of debt to regular installments payable over a period of time.

Actuarial Required Contribution (“ARC”) – Annual contribution rate determined by the actuary to cover the annual costs of a pension plan.

Comprehensive Annual Financial Report (“CAFR”) – Annual financial report prepared by SDCERS’ Staff with the assistance of auditors, investment consultants and actuary.

Contribution Offset – The amount of employee contributions to the Retirement System paid by the City on behalf of the employee. “Offset” is also referred to as “pickup”.

Deferred Retirement Option Program (“DROP”) – A program established effective April 1, 1997, intended to provide employees an alternative form of benefit accrual while working for the City. Members accrue a monthly service retirement allowance calculated as if the member were retiring on the date the member enters DROP. The member and the City contribute equally each pay period on a pre-tax basis. Monies are distributed to the employee upon termination of employment or completion of DROP. A member’s participation in DROP is not to exceed sixty months.

Entry Age Normal (“EAN”) – An actuarial cost method approved by GASB that calculates the expected total cost of a member’s lifetime benefit from the age of entry to retirement as a level percent of payroll.

Excess Earnings – Used interchangeably with “surplus earnings”. The amount by which the investment return for the fund exceeds the actuary’s assumed investment return.

Funding floor – Used interchangeably with “trigger”. Refers to the funded ratio below which System funding could not drop. Used as a safeguard to ensure pension plan was properly funded.

Funded ratio – The ratio of the actuarial accrued liability to the current assets.

Gabriel Roeder Smith (“GRS”) – Actuarial consulting firm to SDCERS’ Retirement Board.

Meet and Confer – The process in which benefits would be negotiated between the City and labor unions.

Public Financial Management (“PFM”) – Financial consultant firm to the City of San Diego.

Projected Unit Cost (“PUC”) – An actuarial cost method approved by GASB that calculates the actuarial liability of a member’s benefits for a particular year.

Purchase of Service Credit (“PSC”) – A five-year feature effective January 1, 1997 that allowed a member to purchase years of service credit by paying both employer and employee contributions. This feature was made available to half-time, three-quarter-time, and full-time employees.

Reish, Luftman, Reicher & Cohen (“Reish Luftman”) – Special fiduciary counsel to SDCERS’ Retirement Board. Navigant Consulting worked under the direction of RLRC.

Seltzer Caplan McMahon Vitek (“Seltzer Caplan”) – Litigation counsel to SDCERS’ Board of Administration.

Surplus Undistributed Earnings - Used interchangeably with “excess earnings”. The amount by which the investment return for the fund exceeds the actuary’s assumed investment return.

Trigger - Used interchangeably with “funding floor”. Refers to the funded ratio below which System funding could not drop. Used as a safeguard to ensure pension plan was adequately funded.

Unfunded Liability – The actuarial accrued liability less the current assets. Also referred to as unfunded actuarial liability or UAAL.

Underfunding – The difference between the amount of the City’s annual contribution to SDCERS between and the Actuarially Required Contribution (defined above).

Waterfall – Refers to the prescribed order in which items are deducted from surplus undistributed earnings.



402 West Broadway
Suite 400
San Diego, CA 92104
619-585-4814 phone
619-595-4849 fax

September 6, 2005

Fred Reish, Esq.
Reish, Luftman, Reicher & Cohen
11755 Wilshire Boulevard
10th Floor
Los Angeles, CA 90025

Re: **Investigation for the Board of Administration of San Diego City
Employees' Retirement System**

Dear Mr. Reish:

This letter confirms the retention of Navigant Consulting, Inc. ("Navigant Consulting") by Reish, Luftman, Reicher & Cohen ("RLRC"), fiduciary counsel for the Board of Administration of San Diego City Employees' Retirement System ("SDCERS"), to perform an investigation of allegations of illegal or wrongful acts (defined below) and/or other improprieties that may have occurred with respect to SDCERS. Navigant Consulting's work on this engagement is being performed at the request of RLRC. Navigant Consulting and RLRC recognize that the specific services to be performed will depend on facts and circumstances that emerge during the course of this engagement.

RLRC agrees to use its best efforts to provide Navigant Consulting with timely access to information, locations and personnel reasonably necessary for the performance of its services. Navigant Consulting's work product is to be used only in relation to the above matter and not for any other purpose without its written approval.

The preparation of Navigant Consulting's work product is an evolving process during which its analysis is focused and refined as its research and document review proceeds, and as information emerges in litigation. Preliminary conclusions, superseded drafts, notations, analyses, work lists, and irrelevant data are not a part of, and will not be recorded in, Navigant Consulting's final work product. Such documents may be appropriately discarded on a routine basis as work tasks are completed. Of course, circumstances may arise that require the retention of such drafts or other interim documents, including but not limited to subpoenas and court orders.

Fred Reish, Esq.
Reish, Luftman, Reicher & Cohen
September 6, 2005
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Project Team, Fees and Expenses

The engagement team will be led by Stephen Jones, a Managing Director in Navigant Consulting's San Diego office, who will be assisted by the following people, whose CVs are attached:

Steve Stanton is a Managing Director in Navigant Consulting's Washington DC office. He has performed several independent investigations for Special Committees. He has experience with pension plans including the Federal Thrift Savings Plan, public employee plans and pension plans of major corporations.

Amanda Massucci is a Managing Director in Navigant Consulting's Los Angeles office. She has performed many independent investigations for Special Committees and Audit Committees involving a variety of financial reporting and accounting matters. She will serve as the local contact and oversee the day to day supervision of the engagement.

The engagement team will include others as appropriate. Navigant Consulting will make every reasonable effort to perform the assignment in a cost-effective manner. It is Navigant Consulting's practice to communicate frequently and clearly on the scope of work performed. The hourly rates outlined below will be in effect through December 31, 2005.

<u>Title</u>	<u>Rate</u>
Directors	\$450 - \$675
Managers	\$350 - \$425
Consultants	\$225 - \$325

Navigant Consulting's hourly rates are based on the experience and skills of the personnel involved and are adjusted periodically, typically on January 1st of each year. Professional services and related expenses at cost with no mark-up will be billed at least monthly based on hours incurred and the rates in effect at the time services are performed. SDCERS will be solely responsible for payment of any invoices rendered by Navigant Consulting with respect to this engagement; therefore, Navigant Consulting agrees that RLRC has no responsibility for payment of any fees, costs or other amounts due to Navigant Consulting under this engagement. Navigant Consulting's bills are due upon receipt, and payment of professional fees and expenses is expected within thirty days of the invoice date. A late charge of 1% per month will accrue on amounts not paid within 30 days of the date of the invoice.

Fred Reish, Esq.
Reish, Luftman, Reicher & Cohen
September 6, 2005
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Navigant Consulting reserves the right to request payment of outstanding fees and expenses prior to submission of its final report or testimony. In addition, Navigant Consulting reserves the right to suspend services until payment is received on past due invoices. Navigant Consulting does not predict or warrant the outcome of any particular matter or issue, and its fees are not dependent on such outcomes.

Upon commencing work on this assignment, a retainer of \$100,000 will be due and payable. This retainer will be applied to the final billing in this matter.

From time to time, Navigant Consulting may give RLRC an estimate of fees and expenses relating to this matter. Such estimates are subject to many unknown or uncontrollable variables. As such, they are only intended as approximate projections at a particular point in time. They may change as we move forward, and they are not intended to be an agreed upon fixed fee amount. It is agreed that any fee estimates Navigant Consulting provides to RLRC will be promptly forwarded to the Board of Administration of SDCERS, and that Navigant Consulting may communicate directly with the Board of Administration and SDCERS regarding billing and other administrative matters. Navigant Consulting is undertaking this engagement on the understanding that RLRC has received the Board of Administration of SDCERS's consent for the retention of Navigant Consulting, that RLRC will timely provide the Board of Administration of SDCERS with a copy of this engagement letter, and that the terms hereof are acceptable to the Board of Administration of SDCERS.

Other Terms and Conditions

Scope of Investigation: In general, Navigant Consulting will perform an investigation of allegations of illegal or wrongful acts, or other improprieties, regarding SDCERS. More specifically, Navigant Consulting will investigate whether the Board of Administration of SDCERS, in its administration of the pension fund and/or management of its assets, violated any laws resulting in a material impact on the financial status of the fund. Furthermore, Navigant Consulting will investigate the adequacy of the funding of the SDCERS pension fund. All determinations relative to funding shall be made in accordance with applicable provisions of the California Constitution and the San Diego City Charter. The investigation will included the years January 1, 1995 through December 31, 2002, inclusive; however, if facts are disclosed that warrant the investigation of additional years, the scope of investigation will be expanded to include such additional years.

Fred Reish, Esq.
Reish, Luftman, Reicher & Cohen
September 6, 2005
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Investigation of facts and Conclusions of law: Navigant Consulting will investigate and report to RLRC any and all facts and related analysis relevant to the determination of whether any illegal or wrongful acts, or other improprieties, have occurred with respect to SDCERS. Navigant Consulting will not, however, make or attempt to make any determinations of law.

Illegal or Wrongful Acts: As contemplated by this agreement, the term "illegal or wrongful acts" refers to acts and/or omissions that violate any laws. The term "illegal acts," as contemplated by this agreement, is not governed by Section 10A of the Securities Exchange Act of 1934, as amended.

Laws: The word "laws," as used in the definition of "illegal or wrongful acts" herein, includes the following: (i) the City of San Diego Charter; (ii) the City of San Diego Municipal Code; (iii) the California Constitution and statutes; (iv) other California fiduciary responsibility rules as established by courts and common law; (v) Federal and state securities laws and related regulations; and (vi) any guidance interpreting items (i) through (v), above.

RLRC Oversight: Navigant Consulting understands that RLRC, in its role as fiduciary counsel, is overseeing the communications to and from the members of the Board of Administration of SDCERS regarding their fiduciary responsibilities and the impact of their actions on the retired and active participants. Therefore, Navigant Consulting must receive RLRC's initial written consent before communicating with any members of the Board of Administration, or SDCERS staff otherwise obtaining information from them.

Confidentiality: Navigant Consulting understands that all communications between Navigant Consulting and RLRC or the Board of Administration of SDCERS, either oral or written, as well as any materials or information developed or received by Navigant Consulting pursuant to this arrangement, are intended to be confidential and, as such, are protected by the attorney-client privilege and/or the attorney-work product doctrine. Accordingly, Navigant Consulting agrees, subject to applicable law or court order, not to disclose any of its communications, or any of the information it receives or develops in the course of its work for RLRC, to any person or entity apart from RLRC or such other persons or entities as RLRC may designate.

If access to any of the materials in Navigant Consulting's possession relating to this engagement is sought by a third party, Navigant Consulting will promptly notify RLRC of such action, tender to RLRC its defense in responding to such request and otherwise cooperate with RLRC concerning its response thereto. In the event that Navigant

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Consulting is subpoenaed as the result of any work performed for RLRC in connection with this engagement, SDCERS will compensate Navigant Consulting for its time involved in responding to such subpoena(s).

Conflicts of Interest: Based on the names of the parties RLRC has provided, Navigant Consulting is not aware of circumstances that constitute a conflict of interest or that would otherwise impair its ability to provide objective assistance. In matters other than this engagement, Navigant Consulting may be asked to assist parties who have interests that may be adverse to those of either RLRC or the Board of Administration, or SDCERS. As independent consultants and experts, Navigant Consulting's determination of conflicts is based primarily on the confidential information that it obtains or develops in the course of its engagement, rather than being based solely on the parties involved. RLRC agrees that its retention of Navigant Consulting on this engagement will not preclude Navigant Consulting from working on unrelated matters that are, or may be, adverse to RLRC or the Board of Administration of SDCERS, provided that Navigant Consulting will not make use of confidential information that it may have obtained from or developed in this engagement for RLRC or SDCERS.

Liability. The total liability of Navigant Consulting and its agents for all claims of any kind arising out of this engagement, whether in contract, tort or otherwise, shall be limited to three (3) times the total fees paid to Navigant Consulting on this engagement. Navigant Consulting shall not be liable for any indirect, consequential or punitive damages. Navigant Consulting shall not be liable for any loss or destruction of any valuable documents provided to Navigant Consulting.

Resolution of Disputes: If RLRC, on behalf of SDCERS, desires to terminate its relationship with Navigant Consulting on this engagement, it may do so at any time for any reason, simply by giving Navigant Consulting written notice. In such event, Navigant Consulting will be paid for fees and expenses through the termination date, as well as for reasonable engagement closing costs. To promote rapid and economical resolution of any disputes which may arise, any and all disputes or claims related to or arising from this agreement shall be resolved by final, binding and confidential arbitration conducted in Los Angeles by JAMS Inc. (formerly Judicial Arbitration and Mediation Services) ("JAMS") under the then-applicable JAMS rules. However, if there is no JAMS office within 75 miles of this location, then the arbitration shall be conducted by the American Arbitration Association ("AAA") under the then-applicable AAA rules. All issues related to interpretation of this agreement or any issues arising out of this engagement shall be governed by the law of California without application of its conflict of laws principles.

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Disposition of Documents: At the end of this engagement, RLRC will have several options with respect to disposition of any documents related to the engagement that Navigant Consulting does not wish to retain in its files. RLRC can (a) direct Navigant Consulting to return all such documents to RLRC, where practicable; (b) authorize Navigant Consulting to discard or destroy such documents; or (c) direct Navigant Consulting to store any or all such documents at the expense of SDCERS. If RLRC does not request one of these options for the disposition of materials within 60 days after this engagement is concluded, Navigant Consulting may implement any one of these options. Navigant Consulting will have the right to retain a copy of its reports or work papers for its records.

Savings Clause: If any provision of this agreement or the application thereof to any person or circumstance is determined to be invalid or unenforceable under applicable law, but such provision does not destroy the basis of the agreement between Navigant Consulting and RLRC as described herein, the remainder of this agreement shall not be affected thereby and shall be enforced to the greatest extent permitted under the law.

Further Assurances: Navigant Consulting and RLRC agree that they will at any time and from time to time, upon the request of the other, or as may be necessary to carry out the purposes and intent of this agreement, execute, acknowledge where required, deliver or perform all such further documents, acts, assignments, transfers, conveyances and assurances as may be required to carry out the terms and provisions of this agreement.

Effective Date: This agreement is effective August 30, 2005.

Counterpart Execution: This agreement may be executed in one or more counterparts, and delivered by facsimile transmission or otherwise, each of which shall be deemed to be an original and all of which together shall constitute one and the same document.

This letter and any agreements expressly incorporated herein constitute the entire agreement between Navigant Consulting, on one side, and RLRC on behalf of the Board of Administration SDCERS on the other side, regarding the terms of this engagement. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein and supersedes any other such promises or representations. It can only be modified by a written agreement signed by duly authorized representatives of each party.

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If RLRC wishes to engage Navigant Consulting to provide the services outlined in this agreement, please sign in the space provided below and return an executed original to me.

I look forward to providing services to you in connection with this matter. If you have any questions, please do not hesitate to call me at 619-595-4826.

Very truly yours,

Navigant Consulting, Inc.

By: _____


Stephen Jones
Managing Director

Date: September 6, 2005

Agreed to and Accepted by:

Reish, Luftman, Reicher & Cohen on behalf of the Board of Administration SDCERS

By: _____



Date: September 6, 2005

San Diego City Employee's Retirement System Workplan

Objectives and Scope:

Perform an investigation of allegations of illegal or wrongful acts and/or other improprieties that may have occurred with respect to the San Diego City Employment Retirement System ("SDCERS"). Unless otherwise indicated, the relevant time frame for documents and reports to be obtained and analyses to be prepared will include the years January 1, 1995 through December 31, 2002, inclusive; however, if facts are disclosed that warrant the investigation of additional years, the scope of investigation will be expanded to include such additional years. We currently contemplate that our analysis will include the System insofar as it relates to City of San Diego employees, Unified Port of San Diego employees and San Diego County Regional Airport Authority employees; most of our work will focus on the City of San Diego employees.

1. Address questions raised by Counsel.
 - a. Were any illegal acts committed regarding the methodology for calculating employer contributions by the City of San Diego at any time from 1995 to the present?
 - b. If so, have sufficient actions been taken to cure the effect of such acts?
 - c. What further actions, if any, are necessary to cure the effect of such acts?
 - d. Is SDCERS' current method of calculating employer contributions in conformity with generally accepted actuarial practices?
 - e. Has SDCERS made proper disclosures in its Comprehensive Annual Financial reports of all relevant information regarding the actuarial soundness of the Retirement System?
 - f. Has SDCERS provided benefits to its members and their beneficiaries in conformity with all System and trust documents as contained in the applicable law (see 5d below)?
2. Address additional questions raised.
 - a. Evaluate the actions of the SDCERS actuary (Roeder) and investment consultant (Callan).
 - b. Investigate whether SDCERS netted its short and long positions in AIG investments and the impact on its financial reporting, if any.
 - c. Analyze cash account to determine if any shortfall exists as of May 2005.
 - d. Any other allegations raised by the City Attorney or knowledgeable parties.
3. Address other issues that arise during the course of the work.

San Diego City Employee's Retirement System Workplan

Background Information:

4. Obtain an understanding of SDCERS Board of Administration ("Board") objectives for the investigation.
 - a. Meetings with fiduciary counsel to the Board.
 - b. Meetings with outside counsel to the Board.
 - c. Meetings with Board members.
5. Gain an understanding of the SDCERS's operations, policies and procedures, organization and other relevant information.
 - a. Meetings with SDCERS staff.
 - b. Review information on SDCERS website.
 - c. Obtain organization charts.
 - d. Review applicable law including:
 1. the City of San Diego Charter;
 2. the City of San Diego Municipal Code;
 3. the California Constitution and Statutes;
 4. other California fiduciary responsibility rules as established by courts and common law;
 5. federal and state securities law and related regulations; and
 6. any guidance interpreting items (1) through (5)?
 - e. Review recent SDCERS Comprehensive Annual Financial Reports ("CAFRs").
 - f. Review System documents, including any documents containing explanation of defined benefits.
 - g. Obtain understanding of decision-making process of Board of Administration
 - h. Review operating budgets.
 - i. Review the compensation model for the SDCERS staff.
 - j. Review Callan Associates reports.
 - k. Review filings with the state, county and/or city.
6. Review other documents and reports to obtain additional relevant information.
 - a. Kroll reports.
 - b. Vinson & Elkins reports.
 - c. Privileged documents released to Kroll.
 - d. Interim reports published on San Diego City Attorney's website.
 - e. Electronic files/emails/correspondences.
 - f. Blue Ribbon Committee Reports.
 - g. Pension Reform Committee reports.
 - h. Internal audit reports.

San Diego City Employee's Retirement System Workplan

- i. City of San Diego CAFRs
 - j. SDCERS management representation letters to external auditors.
 - k. City bond offerings and related documents.
 - l. Rating agency reports.
 - m. City of San Diego summary budgets proposals and approved budgets.
 - n. Mercer Human Resources Consulting operational review report(s).
 - o. Milliman report(s).
 - p. Any other outside reports on the System.
 - q. Board minutes.
 - r. City of San Diego labor union agreements as they relate to System.
 - s. Press releases and news articles.
 - t. Minority reports
 - u. Any additional documents previously produced related to SDCERS pension obligation and funding.
7. Obtain relevant information from SDCERS external auditors.
- a. Review audited financial statements (CAFRs) from 1995-2002.
 - b. Review audit workpapers for the audits of 1995-2002.
 - c. Meet with external audit team members to understand audit scope, issues and assessment of internal control and audit evidence obtained for prior periods (1995-2002).
 - d. Communications from auditors
8. Obtain relevant documents and develop a sufficient understanding of litigation involving the System.
- a. Gleason litigation.
 - b. Corbett litigation.
 - c. Roeder litigation.
 - d. Blum litigation.
 - e. Callan litigation.
 - f. Aguirre allegations and lawsuits filed.
 - g. SEC investigation.
 - h. US Attorney investigation.
 - i. Action for declaratory relief filed by SDCERS in 2005.
 - j. Action filed by Michael Aguirre to appoint a trustee for the System.
 - k. Other litigation/investigations.
9. Identify individuals and conduct interviews (see attached Interview List).

San Diego City Employee's Retirement System Workplan

The System (Actuarial, Accounting and Financial Reporting):

10. Obtain summary information regarding the System, including:
 - a. Number of participants.
 1. Number of current contributors.
 2. Number of individuals receiving pensions.
 3. Number of individuals no longer contributing but due future pension.
 - b. Pension formulas/amounts.
 1. Withholdings/contributions.
 2. Pension payments.
 - c. Summary financial information for relevant time frames, including:
 1. Annual System assets and liabilities.
 2. Annual contributions to System.
 3. Annual pension payments.
 4. Annual investment income/returns.
11. Identify rules and regulations applicable to the System, and summarize key components.
 - a. California constitution.
 - b. California state law.
 - c. San Diego city charter.
 - d. San Diego Municipal code.
 - e. Any applicable Federal laws or requirements
 - f. Applicable accounting pronouncements.
 - g. Any other applicable rules and regulations.
12. Determine and document System funding mechanisms and procedures
 - a. Entities/departments involved.
 - b. Relevant financial institutions and accounts.
 1. Including escrow accounts, clearing accounts, etc.
 - c. Sources of funds.
 1. Employee contributions.
 2. City contributions.
 3. Investment returns.
 - d. Timing/frequency of funding.
13. Determine and document System assets and investment returns during the relevant time frame.
 - a. Cash accounts.

San Diego City Employee's Retirement System Workplan

- b. Investments.
 - c. Investments returns.
- 14. Determine and document System liabilities during the relevant time frame.
 - a. Current obligations.
 - b. Future obligations.
- 15. Determine and document Pension payment mechanisms and procedures.
 - a. Entities/departments involved.
 - b. Relevant financial institutions and accounts/source of funds.
 - c. Timing/frequency of payments.
- 16. Obtain understanding of the accounting for the System.
- 17. Obtain, review and assess the actuarial calculations and assumptions used by SDCERS.
 - a. Meetings with SDCERS actuaries.
 - b. Review other actuarial reports and calculations.
 - c. Identify key actuarial assumptions and changes thereto.
 - d. Assess the level of employee contributions to the System and determine if additional employee contributions are required.
 - e. Perform analysis comparing the performance of the SDCERS System to other large city pension plans and corporate pension plans.
 - 1. Identify and obtain any reports, survey results performed by outside organizations regarding city pension plans.
 - 2. Compare SDCERS' actuarial assumptions to those used by other cities' pension plans.
 - 3. Analyze the funding status of other cities' pension plans.
 - 4. Compare other cities' bond ratings to San Diego.
- 18. Assess changes to the System over time.
 - a. Conversion from entry age normal (EAN) actuarial cost method to projected unit credit (PUC) funding method (in 1991).
 - b. Changes to amortization period (in 1991 and later).
 - c. "13th Check"
 - d. Manager's Proposal 1 ("MP1").
 - e. Manager's Proposal 2 ("MP2").
 - f. Any other changes to pension benefits.
 - g. Option to buy past and future service credit.
 - h. Any "Waterfall" effect as discussed in SDMC Section 24.1502.
 - i. Impact of the Deferred Retirement Option Program ("DROP").

San Diego City Employee's Retirement System Workplan

- j. Impact of Gleason settlement.
 - k. Impact of Corbett settlement.
19. Perform analysis.
- a. Compare Board approved funding amounts to actuarial calculations.
(Note: this comparison is already included in the CAFR.)
 - b. Analyze the unfunded accrued actuarial liability ("UAAL") over time.
 - c. Review SDCERS' compliance with state, city or other municipality's laws.
 - d. Review SDCERS' compliance with actuarial standards.
 - e. Review SDCERS' compliance with GASB.
 - f. Analyze any accounting/financial reporting issues, to the extent not already covered
 - g. Analyze funding rate as percentage of city's budget and assess impact of changes to the System on the funding rate.
 - h. Assess impact of analyses on City's bond disclosures.
20. Compliance testing.
- a. Test a statistically valid sample of SDCERS benefit payments for compliance with the System documents.
21. Understand the policies, procedures and changes thereto with respect to retiree healthcare benefits.
- a. Assess the respective roles and responsibilities of the System and the City of San Diego with respect to health care benefits.
 - b. Assess the changes to the responsibilities of the System and the City of San Diego and the impact, if any, on the System's funds.
 - c. Determine if any funds from the System have been used to fund health benefits for City of San Diego employees.
 - d. Determine the Board's role with respect to these benefits.
 - e. Determine the financial reporting implications of the health care program.
22. Understand and assess the Police Department's FIT program, which provides a personalized fitness program for officers in the Police Department, with respect to disability claims file with the System.

Board Governance and Control:

23. Analyze SDCERS' Board governance policies and procedures.

San Diego City Employee's Retirement System Workplan

Reporting:

24. Follow-up inquiries based upon interviews and analyses.
25. Analyze results and form conclusions. Navigant Consulting will not make or attempt to make any determinations of law.
26. Report on results of the investigation.
 - a. Findings and action items to address the objectives outlined in Step 1 above.
 - b. Recommendations regarding policies, procedures and governance matters.

San Diego City Employees' Retirement System Interview List

- 1) SDCERS staff
 - a) Larry Grissom (System Administrator)
 - b) Lori Chapin (General Counsel)
 - c) Doug McCalla (Chief Investment Officer)
 - d) Patrick Lane (Chief Financial Officer)
 - e) Antonio Santos (Internal Auditor)
 - f) David Arce (Operations Division Manager)
 - g) Other staff as identified
- 2) Past and Current SDCERS Board Members
 - a) Peter Preovolus (President)
 - b) Dick Kipperman (new Board Member 2005)
 - c) Steve Meyer (General Member Representative)
 - d) Joe Flynn (Retiree Rep)
 - e) Bill Lopez (City Manager Designee)
 - f) Thomas Page (Appointee)
 - g) William Sheffler (Appointee)
 - h) Susan Snow (Appointee)
 - i) Mark Sullivan (Police Rep)
 - j) John Thomson (Fire Rep)
 - k) John Torres (General Member Representative)
 - l) Robert Wallace (Appointee)
 - m) Frederick Pierce (former President)
 - n) John Casey (General Member Representative)
 - o) Ray Garnica (council Appointee)
 - p) David Crow (Retiree Representative)
 - q) Tom Rhodes (Safety/Police Representative)
 - r) Richard Vortmann (Council Appointee)
 - s) Ron Saathoff (Fire/Safety Representative)
 - t) Cathy Lexin (City Manager)
 - u) Terri Webster (City Auditor/Formal Assistant City Auditor)
 - v) Mary Vattimo (City Treasurer)
 - w) Diann Shipione (Council Appointee)
 - x) Sharon Wilkinson (General Member Representative)
 - y) Dave Wood (Former President)
 - z) Nancy Acevedo (Former President)
 - aa) Keith Enerson (President of Retired Fire and Police Association, former Board member)
 - bb) Other Board members as identified

San Diego City Employees' Retirement System Interview List

- 3) City of San Diego Employees
 - a) Ed Ryan (Former City Auditor)
 - b) P. Lamont Ewell (City Manager)
 - c) Jack McGrory (former City Manager)
 - d) Patricia Frazier (Former Deputy City Manager)
 - e) Phil Phillips (Former City Accountant)
 - f) Lisa Irvine (Director, Financial Management Department)
 - g) Sally Zumwalt (Former Board of Administrators' Secretary)
 - h) Don McGrath
 - i) Dick Murphy (Former Mayor)
 - j) Susan Golding (Former Mayor)
 - k) Toni Atkins (Deputy Mayor/City Council member)
 - l) Current and former City Council Members, to be determined
 - i) Scott Peters
 - ii) Jim Madaffer
 - m) Michael J. Aguirre (City Attorney)
 - n) Other employees of the City Attorney's office, to be determined
 - o) Ann Smith, attorney for Municipal Employees Association
 - p) Current mayoral candidates, Donna Frye and Jerry Sanders
 - q) Mike Uberuaga (Former City Manager)
 - r) Current and Former Union Presidents
 - s) Les Gerard (Former Assistant City Attorney)
 - t) Rick Ruverna (formerly in the City Attorney's office)
 - u) Chris Morris (formerly in the City Attorney's office)
 - v) Elmor Heap (City Attorney designee who negotiated MP2)
 - w) Bruce Herring (former Assistant City Manager)
 - x) Other City employees as identified
- 4) Outside Counsel for SDCERS
 - a) Reish Luftman Reicher & Cohen
 - b) Seltzer Caplan McMahon Vitek
 - c) Robert Blum
 - d) Other counsel for SDCERS
- 5) Outside Counsel for the City of San Diego
 - a) Vinson & Elkins
 - b) Wilke, Farr & Gallagher
 - c) Other counsel for the city

San Diego City Employees' Retirement System Interview List

- 6) Outside Accountants
 - a) Calderon, Jaham & Osborne (FY 2000 - 2002 Auditors, subsequently acquired by Caporicci & Larson)
 - b) Caporicci & Larson (FY 2003 Auditors)
 - c) Brown & Armstrong (Current Auditors), including Andrew Paulden (audit partner)
 - d) KPMG (City of San Diego Auditors)
- 7) Outside Consultants to SDCERS
 - a) Rick Roeder, Gabriel Roder, Smith & Co. (Actuary)
 - b) James Callahan, Callan Associates (Investment Consultant)
 - c) Nancy Williams, lead consultant on Mercer operational review
 - d) Nell Hennessy, President of Fiduciary Counselors
- 8) Other
 - a) Blue Ribbon Committee on City of San Diego Finances members, including April Boling, Richard Vortman and any others as necessary.
 - b) Pension Reform Committee members, including April Boling and Judie Italiano and any others as necessary.
 - c) San Diego Union Tribune reporter(s)
 - d) Any other individuals as identified

Navigant Consulting, Inc.

Status of Investigative Interviews

Interviews conducted: 57

Number of Interviewees: 47

Andrew Paulden, Brown & Armstrong audit partner
Ann Smith (MEA attorney) - interviewed twice
Bill Farrar (Former POA President)
Bill Lopez (New Board member who has since resigned)
Chris Morris (City Attorney's Office)
Conny Jamison (Office of City Treasurer - retired, former SDCERS Board member)
David Arce (SDCERS' Operations Manager)
David Callaghan (Kroll Inc.)
Dawn Clarke (SDCERS' Assistant Chief Investment Officer)
Dean Roberts (Supervising Management Analyst, including Retirement)
Dick Kipperman (Current Board member)
Don McGrath (City Attorney's office)
Doug McCalla (SDCERS' Chief Investment Officer)
Elmer Heap (City Attorney's office)
James Callahan (Investment Consultant)
Jim Maddaffer (City Council member)
Joe Flynn (Current Board member)
John Thomson (Current Board member)
Judie Italiano (MEA President) - interviewed twice
Keith Enerson (Former SDCERS Board president)
Larry Grissom (System Administrator) - interviewed multiple times
Lisa Irvine (Director, Financial Management Department)
Loraine Chapin (SDCERS' General Counsel) - interviewed multiple times (B)
Mark Sullivan (Current Board member)
Michael Aguirre (City Attorney)
Michael Leone (Setzler, Caplan, Mahon & Vitek) - interviewed twice
Nancy Acevedo (Former President, City of San Diego Retired Employees Assoc.)
Nancy Williams (Former Mercer consultant)
Nell Henessey (CEO, Fiduciary Counselors, Inc.)
Patrick Lane (SDCERS' staff)
Peter Prevolos (Current Board member)
Reg Vitek (Setzler, Caplan, Mahon & Vitek) - interviewed twice
Richard Vortmann (Former Board member)
Rick Duvernay (Former City Attorney)
Rick Roeder (Former SDCERS' actuary)

Navigant Consulting, Inc.

Status of Investigative Interviews

Interviews conducted:

Roxanne Parks (Assistant General Counsel)
Sally Zumult (Former SDCERS' staff)
Scott Peters (City Council member)
Steve Meyer (Current Board member)
Steven DeVetter (KPMG audit partner)
Susan Golding (Former Mayor)
Susan Snow (Former Board member)
Toni Atkins (Deputy Mayor)
Tony Santos (SDCERS' Internal Auditor)
Troy Dahlberg (Kroll Inc.)
William Haegele (KPMG forensic director)
William Sheffler (Current Board member)

Interviewees who agreed to provide answers to written questions in lieu of an in-person interview:

4

Ann Parode (Former Board member - MP1)
Joan Raymond (Local 127 Union President)
Lamont Ewell (City Manager) (C)
Les Gerard (Former City Attorney's office) (C)

Interviewees contacted who declined to be interviewed:

20

April Boling (Pension Reform Committee member)
Cathy Lexin (Former Board member) (A)
David Crow (Former Board member)
Donna Frye (City Council member)
Gary Caporicci (Former audit partner)
Jack McGrory (Former City Manager)
Jerry Sanders (Mayor Elect)
Joe Wyatt (Former fiduciary counsel)
John Casey (General Member Representative)
John Graham (Former fiduciary counsel - affiliated with Dwight Hamilton)
John Torres (Former Board member) (A)
Loraine Chapin (SDCERS' General Counsel) (B) - excluded from count since included above
Mary Vattimo (Former City Treasurer) (A)
Michael Toumanoff (Former fiduciary counsel)
Mike McGhee (City Labor Relations Manager)

Navigant Consulting, Inc.

Status of Investigative Interviews

Interviewees contacted who declined to be interviewed:

Mike Uberuaga (Former City Manager)
Patricia Frazier (Former Deputy City Manager)
Phil Phillips (Former City Accountant)
Ray Garnica (Former Board member - Council Appointee)
Sheila Leone Jacobs (SDCERS' Associate General Counsel)
Tom Rhodes (Safety/Police Representative)

People Unable to be Scheduled during Interview Phase of Investigation

7

Bill Nemec (POA President, effective January 2005)
Bruce Herring (Former Deputy City Manager)
Dave Wood (Former President of Retired Employee Association)
Diann Shipione (Former Board member) - preliminary hearing testimony
Lamont Ewell (City Manager) (C) - included above
Les Gerard (Former City Attorney's office) (C) - included above
Robert Wallace (Former Board member - 2005)
Thomas Page (Former Board member - 2005)
Tom King (Former Board member - 2005)

People contacted from whom we have not received a response:

8

Conny Hiatt (Former Fiduciary Counsel) (A)
Dick Murphy (Former Mayor)
Ed Ryan (Former City Auditor)
Frederick Pierce (Former President)
Robert Blum (Former Fiduciary Counsel) (A)
Ron Saathoff (Fire/Safety Representative) (A)
Sharon Wilkinson (General Member Representative) (A)
Terri Webster (City Auditor/Formal Assistant City Auditor) (A)

Deceased Individuals:

3

Dwight Hamilton (Former Fiduciary Counsel to SDCERS' Board)
Jack Katz (Former Board member)
Paul Barnett (Former Assistant Administrator and Board member)

Total number of individuals

89

Navigant Consulting, Inc.
Status of Investigative Interviews

Notes:

- (A) Deposition transcript available
- (B) Although Navigant Consulting conducted preliminary interviews of Ms. Chapin to discuss SDCERS' operations and certain emails authored by Sheila Leone, Ms. Chapin declined to be interviewed regarding other topics and events.
- (C) The attorney for this individual agreed to respond to written questions, but this has not occurred as of January 20, 2006.

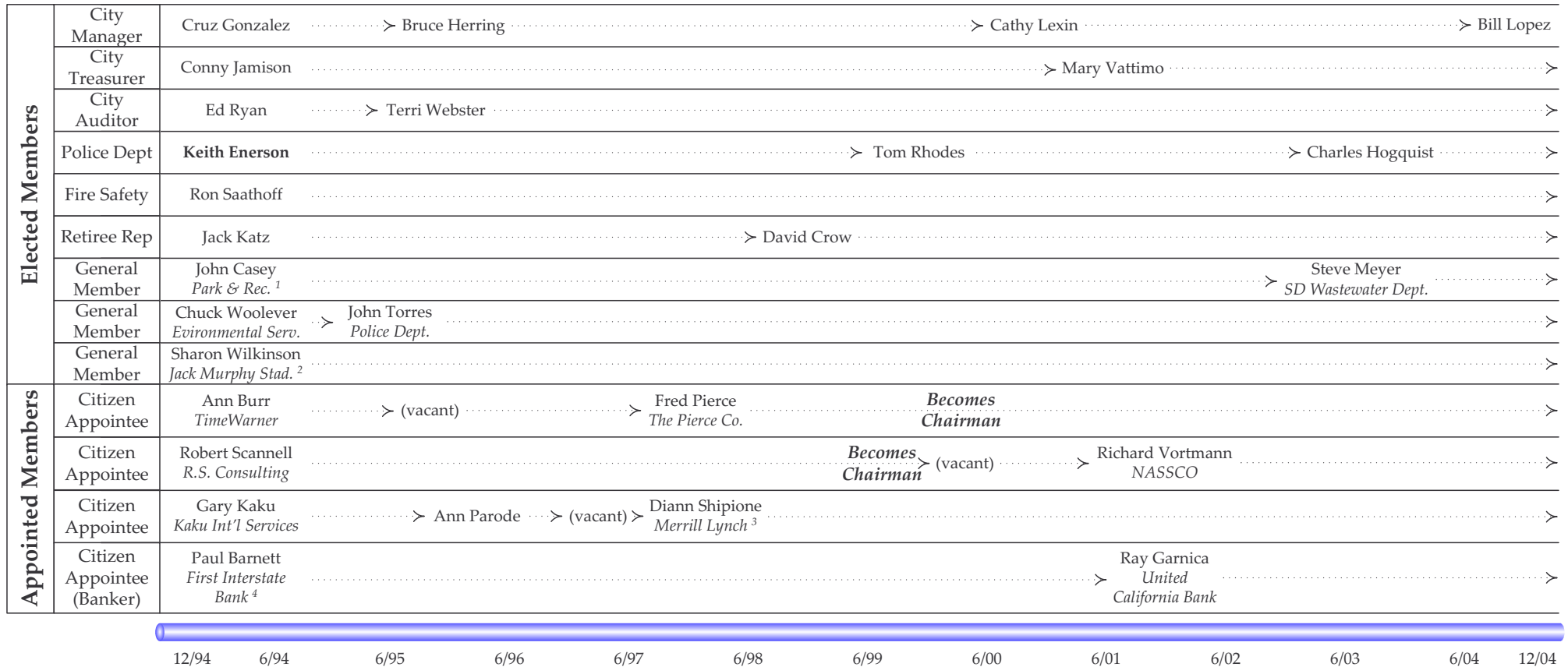
Navigant Consulting, Inc.

SDCERS Investigation

List of Search Terms Used

"DROP" and "cost"	EAN	Medical benefit*
"DROP" and "interest"	employee union*	meet and confer
"DROP" and "liability"	employer contribution reserve	Minority Report*
Benefits	Entry Age Normal	Minutes
10-K	Error*	Mofo
13th Check	Excess earnings	Morrison
Accrued actuarial liability	Faatz*	Morrison & Foerster
Accrued liability	Fiduciary*	MP*
Actuar*	financial statement*	Opinion
Ad hoc committee	FIT	Osborn
Aguirre	Fraud	Overpaid
AIG	Fund*	Participant
amortization	GAAP	Pension Reform
Andrews	GASB	PFM
ARC	Generally Accepted Accounting Principles	presidential leave
Audit Adjustment	Gleason	Projected Unit Credit
audit*	Government Accounting Standards Board	Public Financial Management
balloon	Hamilton*	PUC
Barnett	Hanson Bridgett	purchase of service credit
Blue Ribbon	Health*	quid pro quo
Blum	Hiatt	Rep* letter
breach	hide	Roeder
C&L	Hogquist	SEC
CAFR	Illegal	Service Credit Amount
Calderon	Improper	Service Credit Cost
Caporicci	Indemni*	Service Credit Price
Cash account	Irregular	stabilization reserve
Cash overdraft	Jaham	Story-Parks
CJO	Jones Day	Sunset
Comprehensive Annual Financial Report*	Labor negotiation*	Surplus earnings
Confer	Labor Union*	Trigger
Conflict	Larson	U.S. Attorney
Contingenc*	Leavit*	UAAL
Contingency reserve	Leone	Under fund*
Contingent	lump sum	Underfund*
Contrib*	lump-sum	Unfund*
Corbet*	Manager Proposal*	union president
Deferred Retirement Option Program	Manager Response*	Undistributed earning*
Disability income	Managers Proposal*	Unlawful
Disclos*	Managers Response*	US Attorney
Dwight	Material weakness	Violat*
Dwight Hamilton	McHorney	Waterfa*
		Wyatt

San Diego City Employees' Retirement Systems (sdCERS)
Board of Directors Timeline
December 1994 - December 2004



* The Board is comprised of thirteen members; names in bold represent the Chairmans of the Board.

¹ John Casey transferred to the Department of City Planning & Development in 1996/1997.

² Sharon Wilkinson transferred to Qualcomm Stadium in 1996/1997.

³ Diann Shipione transferred to UBS/Paine Webber in 1996/1997.

⁴ Paul Barnett transferred to Wells Fargo Bank in 1996/1997.

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